THE COMPANIES ACT 2006 – A Review of the Key Provisions
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INTRODUCTION

1. This seminar will focus on the most significant recent development in Company Law which is the passing of the Companies Act 2006. It received Royal Assent on 8 November 2006. The full text with explanatory notes and destination tables is available online from www.opsi.gov.uk/ACTS/acts2006a.htm. The Act is both a reforming/amending Act and a consolidating measure, comprising, effectively, a complete code of company legislation intend to replace the bulk of the current Companies Acts. Some of the previously law is restated, but much is reformed or new.

THE IMPLEMENTATION TIMETABLE

2. The 2006 Act's provisions consist of 1300 sections and 16 Schedules. These, with limited exceptions, came into force on such days were appointed by the Secretary of State or the Treasury. The exceptions which all came into force upon enactment relate to the transparency obligations in Part 43 (implementing the Transparency Directive (2204/109/EC)), amendment of the Companies Act (Audit, Investigations and Community Enterprise) Act 2004 relating to the supervision of auditors in Part 44, and some logistical provisions (such as rule making powers) in Part 46: see CA2006 s1300. The bulk of the Act is being implemented by a series of Commencement Orders, of which 8 have now been made. The latest information is available from the Department for Business Enterprise & Regulatory Reform ("BERR"). The website is www.berr.gov.uk/bbf/co-act-2006/.

3. The Secretary of State has power to make general transitional provisions under s1296, and specific transitional provisions under other sections, while s1297 (continuity of the law) contains general transitional provisions. The commencement orders contain detailed transitional provisions. In addition there are wide powers to introduce subordinate rules and regulations by

statutory instrument in ss 1288-1294 (including amending legislation considered necessary or expedient in consequence of any provisions made by or under the Act), and a large number of regulatory statutory instruments have been and are continuing to be made under these powers. Subordinate legislation is an important element of the legislative framework. Commencement and transitional provisions, and subordinate regulations, introduce substantial complexities into the new statutory regime.

Provisions commenced in January 2007

4. Certain provisions in the Act giving effect to amendments to the First Company Law Directive came into force on 1 January 2007. These changes are in large part designed to ensure increased facilities for e-communications with the national registrar of companies.

5. Also, from 1 January 2007, the Companies Act 1985 as amended requires the company's name to appear legibly in:

   (a) all its business letters
   (b) all its notices and other official publications
   (c) all its websites
   (d) all bills of exchange, promissory notes, endorsements, cheques, orders for money or goods purporting to be signed by or on behalf of the company, and
   (e) all bills of parcels, invoices, receipts, letters of credit.

6. In addition, the company's business letters, order forms and websites have to include fuller particulars, i.e.

   (a) the company's place of registration and the number with which it is registered
   (b) the address of its registered office
   (c) in the case of an investment company, the fact that it is such a company, and
   (d) in the case of a limited company exempt from the obligation to use the word "*limited*" as part of its name, the fact that it is a limited company.

   All these requirements apply whether the document is in hard copy or electronic or any other form.

7. With effect from 20 January 2007, the following provisions linked to implementation of the Transparency Obligations Directive commenced:

   * Provisions on company communications to shareholders and others, which include provisions facilitating electronic communication;

* Provisions concerning a public company's right to investigate who has an interest in its shares;

* Section 463, which sets out a statutory basis of directors' liability to the company in relation to the directors' report (including the business review), the directors' remuneration report and any summary financial statement derived from such reports;

8. All powers to make orders or regulations by statutory instrument were commenced with effect from 20 January 2007.

Provisions commenced in April 2007

9. The most significant part of the 2nd Commencement Order which came into force on 6 April 2007 brought in Part 28 (Takeovers) connected with implementation of the EU Takeovers Directive. These provisions, placing the regulatory activities of the Takeover Panel within a wholly statutory framework, replaced Regulations which came into force on 20 May 2006 and implemented the Directive on an interim basis whilst the Companies Act completed Parliamentary passage (SI 2006/1183).

10. With effect from 6 April 2007, the following provisions in the Companies Act 2006 commenced:

* Section 1063 which relates to fees payable to the Registrar of Companies;

* Section 1281 of the Companies Act, which amends Part 9 of the Enterprise Act 2002 to give the Secretary of State the power to make an order enabling public authorities to disclose information to be used in civil proceedings or otherwise for the purpose of establishing, enforcing or defending legal rights;

* The first Commencement Order also brought into force with effect from 6 April 2007 the free-standing repeal of a number of provisions of the Companies Act 1985:

  s.41 - provisions on authentication of documents
  s. 293 & 294 - age of directors
  s. 311 - prohibition on tax free payments to directors
  s.323 & 327 - prohibition on directors dealing in share options
  s.324-326 and 328- 329 and parts 2 to 4 of Schedule 13 (disclosure of share dealings by directors and their families)

s.343 & 344 - provisions for banking companies etc in respect of loans to directors
s.358 - power to close register
s.438 - power of secretary of state to bring civil proceedings on a company's behalf
s.720 - requirement that certain companies publish a periodical statement.
s.729 - requirement that the Secretary of State prepare an annual report

Provisions commenced 1 October 2007

11. The following provisions commenced with effect from 1st October 2007:

Part 9 (Exercise of members' rights);
Part 10 (A company's directors), other than provisions relating to directors' conflict of interest duties, directors' residential addresses and underage and natural directors;
Part 11 (Derivative claims and proceedings by members);
Part 13 (Resolutions and meetings), and, related to this, sections 485-488 of Part 16 (Audit);
Part 14 (Control of political donations and expenditure);
Section 417 of Part 15 (Contents of directors' report: business review);
Part 29 (Fraudulent trading);
Part 30 (Protection of members against unfair prejudice);
Part 32 (Company investigations: amendments).

Provisions commenced 6th April 2008:

12. The following provisions commenced with effect from 6th April 2008:

Section 44 (Execution of documents);
Section 121 and 128 (Register of members: removal of entries belonging to former members).
Part 12 (Company secretaries) other than section 270(3)(b)(ii) and sections 275 to 279;
Part 15 (Accounts and reports), other than section 417 and 463;
Part 16 (Audit), other than sections 485-488;
Part 19 (Debentures);
Part 20 (Private and public companies);
Part 21 (Certification and transfer of securities);
Sections 811(4), 812 and 814 (Inspection of register of interests in a company's shares);
Part 23 (Distributions);
Part 26 (Arrangements and reconstructions);

Part 27 (Mergers and divisions of public companies);
Section 1172 (References to requirements of this Act);
Part 42 (Statutory auditors);
Section 1282 (Payment of expenses of winding up).

Proceedings Commenced 1st October 2008:

13. The following provisions commenced with effect from 1st October 2008:

Sections 69 to 74 (Objection to company names);
Sections 82 to 85 (Trading disclosures);
Sections 155 to 159 (Provisions relating to corporate directors and under-age directors);
Sections 175 to 177, 180(1), (2)(in part) & (4)(b), & 181(2) & (3) (General duties of directors in respect of conflicts of interest);
Sections 182 to 187 (Declaration by a director of an interest in an existing transaction or arrangement);
Control of political donations and expenditure: provisions relating to independent election candidates;
Sections 544, 641(1)(a) & (2)-(6), 642, 643, 652 & 654 (Share capital provisions, mostly introducing the new solvency statement procedure for capital reduction for private companies);
Section 1157 (Power of court to grant relief in certain cases);
Sections 1277 to 1280 (Information as to exercise of voting rights by institutional investors).

The commencement order will also repeal the restrictions under the Companies Act 1985 on financial assistance for acquisition of shares in private companies, including the "whitewash" procedure.

With effect from October 2009:

14. The following remaining parts of the Act came into force on 1st October 2009 with only limited exceptions.

Part 1 (General introductory provisions);
Part 2 (Company formation);
Part 3 (A company's constitution);
Part 4 (A company's capacity and related matters);
Part 5 (A company's name);
Part 6 (A company's registered office);
Part 7 (Re-registration as a means of altering a company's status);
Part 8 (A company's members);

Part 10 (A company's directors)-provisions relating to directors' conflict of interest duties, directors' residential addresses and underage and natural directors
Part 12 (Register of Secretaries)
Part 17 (A company's share capital);
Part 18 (Acquisition by limited company of its own shares);
Part 24 (A company's annual return);
Part 25 (Company charges);
Part 31 (Dissolution and restoration to the register);
Part 33 (UK companies not formed under the Companies Acts);
Part 34 (Overseas companies);
Part 35 (The registrar of companies);
Part 37 (Company records, service addresses, independent valuation);
Part 40 (Company directors; foreign disqualification);
Part 41 (Business names).

CHANGES AIMED AT SMALLER COMPANIES

15. According to the government, a major aim of the Act was to introduce a simpler, and more lightly regulated, regime for private companies. The provisions relating to all companies are generally set out first in the Act, followed by the extra requirements which apply to public and quoted companies. The Act applies certain provisions only to "*quoted*" companies. It should be noted that these are defined in the Act to include companies on the Official List of the London Stock Exchange but do not include companies on AIM.

16. The government's aspiration to make the law more relevant to smaller companies has been the subject of numerous statements (although the extent to which this has been achieved is debatable).

    * *"Better Regulation is at the heart of the Bill. As it stands, our company law was originally designed for large companies with numerous public investors, but over 90 per cent of companies have five shareholders or fewer. We have lifted from private companies the burden of unnecessary provisions, and drafted the provisions they use most often in a more accessible way."* - Lord Sainsbury of Turville

    * According to the DTI website *"The Act has substantially rewritten company law to make it easier to understand and more flexible, especially for small businesses"*

17. Key changes which are intended to assist smaller companies are:

    * Abolition of the requirement to appoint a company secretary

- * Abolition of the financial assistance provisions for private companies to purchase their own shares

- * New procedures for capital reduction

- * Abolition of the requirement for private companies to hold Annual General Meetings and widening of written resolution procedures

- * New default Articles of Association

Company Secretaries

18. Private companies will no longer need to have a company secretary but if they do, the secretary will have the same authority as currently. i.e. the secretary can continue to be a co-signatory for the execution of documents by the company. Details of any secretary must continue to be recorded in the company's register of secretaries and notified to Companies House.

Financial Assistance for the Acquisition of their own shares

19. The Act abolishes the prohibition on most private companies providing financial assistance for the acquisition of their own shares. Private company subsidiaries of public companies will still be prevented from giving financial assistance. Moreover, subsidiaries which are public companies will not be permitted to give financial assistance for the acquisition of shares in a holding company which is a private limited company. Private companies involved in relevant types of refinancing schemes will no longer need to undergo the expense of the *whitewash* procedure, resulting in a substantial saving of legal fees.

New Procedures for Reductions in Share Capital

20. A simplified procedure for private companies to reduce their share capital has been introduced by the Act. The current procedure which involves obtaining approval from the court will no longer need to be followed. Instead, companies will merely need to pass a special resolution accompanied by an appropriate solvency statement from the directors.

21. The solvency statement will state that the company is solvent and will be able to pay its debts at all times within a year of the capital reduction. Making a solvency statement without reasonable grounds for the opinions expressed in it will be a criminal offence. The procedures will be similar to those which apply

currently when a company wishes to redeem or purchase its own shares out of capital. The ability for a private company to purchase its own shares and issue redeemable shares, and to do so out of capital, has been retained with lighter regulation (in particular by not requiring specific authorisations in its articles).

Abolition of AGM requirement & Written Resolutions

22. Small companies frequently ignore their requirement for AGMs. The Act has taken account of this practice so private companies will no longer need to hold an AGM, unless they wish to do so. Consequently, private companies will no longer need to lay accounts before the AGM, although shareholders will still be entitled to receive the accounts.

23. The Act will make it easier for shareholders of private companies to make most decisions by written resolution and without a general meeting. A 75 per cent majority of all the eligible votes (not just those cast) will be required to pass a written special resolution and a simple majority of all the eligible votes will be required to pass a written ordinary resolution. Unanimity will no longer be required and the written resolution will no longer need to be sent to the auditors. The resolution may also be circulated to the members electronically, for example, by publication on a website.

24. However a general meeting will still be needed where the business to be transacted concerns the removal of a director or an auditor.

New Default Articles of Association

25. Previously, model articles were prescribed for all companies limited by shares in *"Table A"* (contained in the Companies (Tables A to F) Regulations 1985). If a company limited by shares had not registered articles in an alternative form, or if it has registered articles but they did not exclude all the provisions of Table A, the provisions of Table A applied by default to the extent that the company's own registered articles did not exclude or modify them.

26. The Act does not change the principle of model articles, but it does give the Secretary of State power to make regulations prescribing model articles for different descriptions of company. Instead of there just being one set of model articles for all companies limited by shares, public and private companies limited by shares are to each have different model articles. The model articles prescribed for companies of each of these types will apply to any company of that type which is formed and registered under the Act, to the extent that it does not choose to modify or exclude the provisions of the relevant model articles in its own registered articles.

27. Under the Act, the articles will serve some of the functions previously served by the Memorandum of Association. In future, key information regarding the internal allocation of powers between the directors and members of a company will be set out in one place: the Articles of Association. Also, instead of companies being required to specify their objects in the memorandum, companies will have unrestricted objects unless the objects are specifically restricted by the articles.

28. The memorandum has not been abolished but now serves only a limited historic purpose - it must be in the prescribed form and simply evidences the intention of the subscribers to the memorandum to form a company and become members of that company on formation. In the case of a company that is to be limited by shares, the memorandum also provides evidence of the members' agreement to take at least one share each in the company. The memorandum of a company formed under the Act will, therefore, look very different from that of a company registered under the 1985 Act. It will not be possible (and there will never be a need) to amend the memorandum of a company formed under the Act. There are new provisions enabling companies to "entrench" provisions in their articles (to the extent desired) which replace the less flexible entrenchment provisions which could previously have been contained in the memorandum.

29. By virtue of section 28, provisions in the memoranda of existing companies will be treated as provisions in the articles if they are of a type that will not in be in the memoranda of companies formed under the Act. Existing companies will, therefore, not be required to amend their articles to reflect these changes, but they can do so if they wish. They will however be able to alter or update provisions in their memoranda as if they were contained in their articles, for example to reflect changes to the law made by the Act.

Burdens on smaller companies

30. Owners of smaller companies may be less enamoured by provisions in the Act which increase the administrative burden on them eg:

* s.228 -A company must keep available for inspection copies of every director's service contract entered into by the company or by a subsidiary of the company. If the contract is not in writing, the company must keep available for inspection a written memorandum of its terms. Failure to do so is now a criminal offence.

* s.231 - Contracts entered into by a limited company with its only member other than in the ordinary course of the company's business must be recorded in writing if the sole member is also a director or shadow director of the company. A similar provision was introduced

under s322B of the 1985 Act but now if a company fails to comply an offence is committed by every officer of the company who is in default.

* s.248 - Minutes of directors' meetings need to be kept for 10 years. Failure to do so is now a criminal offence.

* s.252 - The definition of *"connected person"* is extended to include parents, adult children and step children, persons with whom the directors lives in an enduring family relationship and children/ step children of such persons. This is relevant to various provisions eg s.239(4) which states that the ratification of directors' breaches of duty/ negligent acts etc ignores votes cast by members of the company who are *connected persons.*

SHAREHOLDER ENGAGEMENT

31. The Act is intended to give shareholders improved rights:

* Indirect shareholders to have information and voting rights

* Restricted access to shareholders' addresses on the register of members

* Extended rights to sue directors for negligence and other defaults - the statutory derivative action

Indirect shareholders to have information and voting rights

32. The Government has recognised that nominee shareholdings are a common method of share ownership, with the result that the indirect shareholder has effectively been disenfranchised. The Act will make it easier for indirect shareholders (that is, investors who hold shares through intermediaries such as nominee brokers) to exercise their rights.

33. The Act allows all companies, which have amended their articles to allow for this, to extend rights to persons nominated by the registered member (typically, this would be an indirect shareholder of the shares but the provision would permit anyone to be so nominated). This is an opt-in provision of the Act: companies can choose whether to amend their articles to enfranchise indirect shareholders.

34. The Act also gives additional information rights to nominated persons in quoted companies. This is not an opt-in provision: the information rights do not depend on any enabling provision in a quoted company's articles. It should

be noted that a registered member in a quoted company may only nominate someone who holds a beneficial interest in a share in that quoted company. These rights are in addition to the rights of the member and do not affect any opt-in rights.

35. A registered member can nominate another person (nominated person) to enjoy or exercise any or all of the registered member's rights. These include the ability to require the directors to call a meeting and the right to appoint a proxy to act at a meeting, and will enable the nominated person to receive the annual report and accounts.

36. The only right that the registered member must continue to exercise is the right to transfer the shares; this right must remain, as is currently the case, with the registered member. Moreover, it is important to note that these provisions will not enable nominated persons to have directly enforceable rights against a company. Nominated persons will still need to enforce their rights through the member whose name appears on the register.

37. In addition to the above, nominated persons in quoted companies can receive information (for example, shareholder notices, circulars and the annual report and accounts) directly from the quoted company. Subject to shareholders' consent in general meeting, companies will be allowed to communicate with all shareholders, including nominated persons, by posting documents on a website. However, shareholders may request hard copy documents.

38. Where the quoted company sends a notice of meeting to a nominated person, the notice must be accompanied by a statement that the nominated person may, under his agreement with the registered member who nominated him, be entitled to be appointed as, or to appoint someone else to act as, a proxy. If the nominated person does not have such a right, the statement must clarify that he may give voting instructions to the registered member.

39. The enfranchisement of indirect shareholders means that the company register will no longer be the definitive record of those with whom the company must communicate as the company's owners. Instead, company secretaries, (acting, in the case of traded companies, together with the company's registrars) will need to ensure that documents are sent to the nominated holder and that the nominated holder is entitled to exercise the rights transferred to him. This could represent a significantly increased administrative burden.

Restricted access to shareholders' addresses on the register of members

40. Under the old law, members of the public could inspect and obtain copies of the register of members and (for companies with more than 50 members) the index of members' names. The Act changes this by requiring persons to make

a request for access to the register.

41. A person wishing to inspect or obtain copies of the register must submit a request to the company specifying his name and address, the purpose for which the information is to be used and whether it will be disclosed to any other person, and if so, to whom and for what purpose. It will be a criminal offence knowingly or recklessly to make a materially misleading, false or deceptive statement in a request for access. A company can apply to court to refuse an access request if it considers that access is not being sought for a *"proper"* purpose. The Government resisted attempts to include a definition of *"proper"* in the Act. A company will only have five working days to apply to the court and this may be insufficient time for it to form a view about a request for access.

42. Although a company can refuse an access request, the public can still obtain shareholder information by examining a company's annual return (publicly available from Companies House). The Act therefore empowers the Government to pass regulations specifying the content of annual returns. Following consultation, the Government intends to exempt private companies from having to disclose the addresses of members in the annual return and to exempt public companies from having to supply any details of members holding less than five per cent of any class of the company's shares. This, the Government believes, is a practical way of ensuring that the protection given to shareholders' addresses as a result of the Act is not subverted by a requirement to file that information at Companies House, where it is publicly available.

The Statutory Derivative Action

43. For over 150 years the rule in **Foss v Harbottle** (1843) 2 Hare 461 has been a familiar part of the company law landscape. The rule prevents claims by shareholders for reflective losses and provides that if a wrong is done to a company then the company is usually the proper claimant in respect of that wrong.

44. In the light of the general prohibition on claims for reflective losses, the Common Law allowed shareholders under certain circumstances to bring claims on behalf of their companies. The two basic requirements at common law for a derivative action were:

* That the alleged wrong or breach of duty was by a director and was incapable of being ratified by a simple majority of the members (eg a fraudulent breach by a director, the deliberate misappropriation of company assets etc, but not a *bona fide* misuse of powers or an incidental profit making); and

* That the alleged wrongdoers are in control of the company, so that the company, which is the *“proper claimant”* cannot claim by itself.

45. Since October 2007 the provisions in the Companies Act 2006 for a statutory derivative action have been in force. The relevant sections are 260 to 264. Although the two basic common law requirements (set out above) will continue to be relevant to statutory derivative actions, and will play a part in the later stages of any litigation, the absence of one or other is no longer necessarily a bar to the commencement of proceedings.

Who can bring a statutory Derivative Claim?

46. Section 260(1) of the 2006 Act defines a derivative claim as one brought by a member of a company in respect of a cause of action vested in the company and seeking relief on behalf of the company. For this purpose “*member*” includes trustees in bankruptcy and other persons who have been transferred shares by operation of the law. Such a claim can only be brought within chapter 1 of Part 11 of the Act or in pursuance of an order under s.994 (which repeats the unfair prejudice provisions previously found at s.459 of the 1985 Act).

47. No minimum shareholding is required as the amount of the claimant’s interest is irrelevant if the claim is one which should otherwise be brought. **Seaton v Grant** (1867) 2 Ch App 459 at 465. In fact, no shareholding at all is required (eg in cases of claims by members of companies limited by guarantee).

48. Nevertheless, a minuscule holding acquired after the conduct complained of occurred and with a view to commencing a derivative claim may raise concerns about the claimant’s good faith (see **Harley Street Capital v Tchigirinsky** [2005] EWHC 1897 Ch where a claimant acquired 200 £1 shares out of a capital of £230 million).

49. Shareholders who are themselves wrongdoers may be disqualified from bringing a derivative claim. In a case concerning a derivative claim under the Common Law, the Court of Appeal in **Nurcombe v Nurcombe** [1985] 1 WLR 370, 376 approved the following passage from *Gower, Modern Company Law*:

“The right to bring a derivative action is afforded the individual member as a matter of grace. Hence the conduct of a shareholder may be regarded by a court of equity as disqualifying him from appearing as plaintiff on the company's behalf. This will be the case, for example, if he participated in the wrong of which he complains.”

This approach was followed by Lawrence Collins J in **Konamaneni v Rolls**

Royce Industrial Power (India) Ltd [2002] 1 WLR 1269 and ought also to apply equally to statutory derivative claims.

50. Further, a shareholder who wishes to bring a claim purely for his own collateral benefit and not for the benefit of the company will not be entitled to do so. Nevertheless, it has been held that if the claimant intends to bring a derivative claim for the benefit of a company he will not be disqualified from doing so just because there are other benefits that he will derive from the claim. See **Iesini v Westrip** [2009] EWHC 2562 at para 121.

Who can a Derivative Claim be brought against?

51. A key provision of the legislation is subsection 260(3) which states:

"(3) A derivative claim under this Chapter may be brought only 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."

(The reference to "under this Chapter" means that derivative claims brought as a consequence of an unfair prejudice petition are not subject to this restriction)

52. Directors
The main target of derivative claims will be directors. For the purposes of s.260(3) Director is defined to include former directors and shadow directors.

53. Former Directors
The inclusion of former directors avoids the problem that they would otherwise be classed as third parties whom the current board would be expected to sue on behalf of the company. A former director remains subject to the duty (in s. 175) to avoid conflicts of interests as regards the exploitation of any property, information or opportunity of which he became aware at the time he was a director; and subject to the duty (in s 176) not to accept benefits from third parties as regards things done or omitted by him before he ceased to be a director (s.170).

54. Shadow Directors
It would be possible to base a claim against a shadow director on the grounds of 'default', for example, for non-compliance with CA 2006, Pt 10, Ch 4, (Transactions with Directors requiring approval of Members) where many of the provisions expressly apply to shadow directors; and also on the basis of being "another person"for the purpose of CA 2006, s 260(3).

55. Third Parties
The cause of action may be against the director or against another person or both. Any claim against a 3rd party requires a cause of action connected with a

director's conduct. A scenario where a 3rd party would be a defendant would be if the 3rd party dishonestly assisted a director to act in breach of his fiduciary obligations, or if a tracing claim against a 3rd party arose out of some primary wrongdoing committed by the director. It is not necessary to show that the director benefited from the wrongdoing. However, it is not possible for a derivative claim to be brought where the breach of duty etc is solely that of a third party, such as a negligent auditor, since the claim must arise from an act etc by a director.

<u>What causes of action can be pursued by a Derivative Claim?</u>

56. Part 11 of the Act gives shareholders for the first time a statutory right to sue directors in a derivative action on behalf of the company for negligence, default (including breaches of statutory obligations), breach of duty or breach of trust, subject to the court allowing the action to proceed. This covers a broader range of conduct than existed under the Common Law which was based on the concept of a *"fraud on the minority"*. For example, shareholders can now bring a derivative action against directors for negligence even if the directors concerned have not benefited from their negligence. This is a significant change from the Common Law position (see **Pavlides v Jensen [1956] 1 Ch 565**). It is no longer necessary therefore to show that the negligence is of the self-serving variety seen in **Daniels v Daniels** [1978] Ch 406 where the board sold an asset at a gross undervalue to one of the directors. Of course, while negligence will found a derivative claim, the courts will continue to distinguish between mere commercial misjudgements and negligent conduct.

<u>What are the requirements for permission to bring a Derivative Claim?</u>

57. <u>The first hurdle- When must permission be refused?</u>

Section 263(2) sets out three situations in which permission for a derivative claim (not being brought as part of an unfair prejudice petition under s.994) <u>must</u> be refused:

"(2) Permission (or leave) must be refused if the court is satisfied-
(a) that a person acting in accordance with section 172 (duty to promote the success of the company) would not seek to continue the claim, or
(b) where the cause of action arises from an act or omission that is yet to occur, that the act or omission has been authorised by the company, or
(c) where the cause of action arises from an act or omission that has already occurred, that the act or omission-
(i) was authorised by the company before it occurred, or
(ii) has been ratified by the company since it occurred."

58. The difficulties concerning the question of whether someone with a duty acting to promote the success of the company (i.e. a hypothetical independent director) would seek to continue the claim or not were considered in **Franbar Holdings v Patel** [2008] EWHC 1534:

"In my judgment, this is one of those cases in which there is room for more than one view. Directors are often in the position of having to make what is no more than a partially informed decision on whether or not the institution of legal proceedings is appropriate, without having a very clear idea of how the proceedings will turn out. Some directors might wish to spend more time investigating and strengthening the company's case before issuing process, while others would wish to press on with proceedings straight away; in a case such as this one, both approaches would be entirely appropriate. It is my view that there is sufficient material for the hypothetical director to conclude that the conduct of Medicentres' business by those in control of it had given rise to actionable breaches of duty. As it seems likely that Mr Patel and Dr du Plessis were behind much of that conduct, I cannot be satisfied that a hypothetical director acting in accordance with section 172 would conclude that the case advanced was insufficiently cogent to justify continuation of the claim. Even though he may take a healthily sceptical approach to Medicentres' ability to prove the allegations at trial, it does not follow that the claim should not be continued on that ground alone."

The practical effect of this is that so long as a hypothetical independent director might be willing to pursue the claim, then s. 232(2)(b) will not bar a claim.

59. The Second Hurdle- The Discretionary Factors

If an application overcomes the hurdles in s.263(2) the court will then take into account the discretionary factors set out in s.263(3) which states:

"(3) In considering whether to give permission (or leave) the court must take into account, in particular-

(a) whether the member is acting in good faith in seeking to continue the claim;

(b) the importance that a person acting in accordance with section 172 (duty to promote the success of the company) would attach to continuing it;

(c) where the cause of action results from an act or omission that is yet to occur, whether the act or omission could be, and in the circumstances would be likely to be-

(i) authorised by the company before it occurs, or

(ii) ratified by the company after it occurs;

(d) where the cause of action arises from an act or omission that has already occurred, whether the act or omission could be, and in the circumstances would be likely to be, ratified by the company;

(e) whether the company has decided not to pursue the claim;

(f) whether the act or omission in respect of which the claim is brought gives rise to a cause of action that the member could pursue in his own

right rather than on behalf of the company."

60. In addition, the views of any actual independent shareholders (which may match the views of hypothetical directors) need to be taken account of under s.263(4) which states:

"(4) In considering whether to give permission (or leave) the court shall have particular regard to any evidence before it as to the views of members of the company who have no personal interest, direct or indirect, in the matter."

Procedure

61. There is a two stage procedure to weed out the most obviously unmeritorious applications to bring derivative claims. The first stage is a without notice hearing at which the company is not required to attend and for which the company need not file evidence. Only if the judge is satisfied that there is some merit in the application will directions be given for a contested hearing. At the *inter partes* hearing the court does not simply have to be satisfied that there is a *prima facie* claim. Instead something more is required - the court needs to form a provisional view on the strength of the claim to properly consider the requirements of s.263(2)(a) and s.263(2)(b). However the hearing should not amount to a mini trial of the action. See **Iesini v Westrip** [2009] EWHC 2562 and **Fanmailuk.com v Cooper** [2008] EWHC 2198 (Ch).

62. This process is designed to ensure that the Claimant is serious about pursuing the claim and has sufficient grounds to do so. The front loading of costs on the Claimant might deter some of the more frivolous or vexatious claims. Perhaps the most useful consequence is that it will minimise the initial expense that a company need incur if a potential derivative claim obviously lacks merit.

63. Coupled with the new duty to promote the success of the company, concerns have been raised that shareholders, especially activist shareholders of traded companies, will use these provisions to bring unmeritorious claims that will take up valuable management time, as well as result in adverse publicity for the company. However, the reality is likely to be that the Courts will adopt as robust an approach to statutory derivative actions as previously occurred under the common law.

AUDITORS AND REPORTING REQUIREMENTS

64. Quoted companies will no longer need to produce an operating and financial review (OFR). The Act will, however, require all companies (except small companies) to continue to prepare and publish a directors' report which must include an expanded business review. (A small company is, with certain exceptions, a private company which satisfies at least two of the following three criteria: turnover of not more than £6.5 million; balance sheet total of not

more than £3.26 million; and not more than 50 employees.) The exemption for small companies means that the requirement to prepare an expanded business review will not affect the vast majority of private companies.

65. The requirements for narrative reporting have been streamlined so that the requirements for quoted and unquoted companies are broadly similar.

66. In a new provision, the Act states that the purpose of the business review is to inform the company's shareholders and help them to assess how the directors have performed their duty to promote the success of the company. The business review must contain:

* a fair review of the company's business; and

* a description of the principal risks and uncertainties facing the company.

67. The review required is a balanced and comprehensive analysis of:

* the development and performance of the company's business during the financial year; and

* the position of the company's business at the end of that year,

consistent with the size and complexity of the business. This is identical to the current business review provision.

68. In addition, the Act requires quoted companies to ensure that their business review includes, to the extent *"necessary for an understanding of the development, performance or position of the company's business"*

* the main trends and factors likely to affect the future development, performance and position of the company's business;

* information about: environmental matters, the company's employees, social and community issues, persons with whom the company has contractual or other arrangements which are essential to the company's business (this is the controversial "supply chain" amendment introduced into the law by the Government at a late stage).

69. These are almost identical to the matters quoted companies were previously required to disclose by the OFR, thus effectively re-introducing most of the forward-looking, non-financial reporting required by the OFR into the expanded business review.

70. The Government clarified in Parliamentary debate that the supply chain clause

would not require companies to list their suppliers and customers, or to provide detail about contracts. Instead, quoted companies will need to disclose their *"significant relationships"*, such as with major suppliers, key customers or key employees, which are likely to influence the performance of the business and its value. It will be for the directors to judge what they need to report. The Government also agreed that the supply chain clause would not require quoted companies to disclose information about a person if the directors believed that the disclosure would be *"seriously prejudicial to that person and contrary to the public interest."*

71. Directors were concerned about the exposure they could face in respect of the forward-looking statements required by the OFR. Liability will only attach to directors if such statements are untrue or misleading and are made in bad faith or recklessly or, in the case of an omission, there is dishonest concealment of material facts. Further, directors will only be liable to the company, and not to shareholders, potential investors or third parties. The criminal liability regime remains unaffected by this change. The change means that statements included in the expanded business review (including the forward-looking, non-financial elements) will benefit from the safe harbour.

Auditors' Liability

72. Currently, auditors cannot limit their liability in respect of an audit. The Act will permit auditors to agree contractually with their corporate clients to limit their liability in respect of an audit, subject to annual shareholder approval and to the limit being *"fair and reasonable"*. This arrangement is referred to as a liability limitation agreement (LLA). The agreement can only apply to a single year's audit and shareholders must authorise its principal terms. Shareholders in private companies can resolve to waive the need for approval but this waiver must be granted each year in respect of the LLA.

73. The Act provides that in circumstances where there is a dispute as to whether any agreed limit is fair and reasonable, the court must not take into account circumstances arising after the loss or damage in question has been incurred or matters affecting the possibility of recovering compensation from other persons liable in respect of the same loss or damage. This second limb was introduced into the Act to address the concern that at the time of the judgment, the auditors might be the only persons still able to compensate the company and the court may wish to ensure that the shareholders are properly compensated. In a significant change to the law, if a court finds that the limit agreed is not fair and reasonable, it can substitute its own limit and the agreement will remain valid.

74. The Act also introduces a new criminal offence of knowingly or recklessly including a materially misleading, false or deceptive matter in an audit report.

<u>CODIFICATION OF DIRECTORS' DUTIES</u>

The Old Regime

75. The old rules governing directors can come from various sources:

    * The general duties governed by the common law and equity as set out in the cases

    * Specific statutes eg health & safety

    * Companies legislation (eg Companies Act 1985 Part X - s.314 Directors duty of disclosure on takeover, s.317 Directors to disclose interest in contracts, s.318 Service contracts, s.319 Employment contracts, s.320 substantial property transactions etc)

76. The general obligation on directors was that they must act in <u>good faith</u> in the best <u>interests of the company</u>, i.e. in the interests of the shareholders except in times of insolvency when the interests of the creditors must be given priority. There were some exceptions, including a general statutory duty to *"have regard"* to the interests of the company's employees and the duty not to treat minority shareholders unfairly even if such behaviour is for the benefit of the company.

77. Directors' well established fiduciary obligations also required them to avoid conflicts of interest/ not to profit from the office etc. and to use their powers for the proper purposes for which they were conferred upon them.

The New Regime

78. The 2006 Act sets out a new statutory statement of directors' duties – described as their '*general duties'* – in place of the common law and replaces (and to some extent rewrites) Part X Companies Act 1985.

79. The government's description of the impact of these duties has not been entirely consistent:

    "It simply codifies the existing common law obligations" Margaret Hodge, DTI Minister

    "A radical historic and vital cultural change in the way companies conduct their business" Margaret Hodge, DTI Minister

80. This inconsistency is reflected in the statute. The intended replacement of the common law principles is indicated by subsection 170(3) which provides:

> *"(3) The general duties are based on certain common law rules and equitable principles as they apply in relation to directors and have effect <u>in place of those rules</u> and principles as regards the duties owed to a company by a director."*

However, subsection 170(4) suggests that the new regime will not necessarily be a significant departure from familiar principles:

> *"(4) The general duties shall be interpreted and applied in the same way as common law rules or equitable principles, and <u>regard shall be had</u> to the corresponding common law rules and equitable principles in interpreting and applying the general duties.*"

81. Section 171 is unsurprising. It provides:

> *"171 <u>Duty to act within powers</u>*
> *A director of a company must-*
> *(a) act in accordance with the company's constitution, and*
> *(b) only exercise powers for the purposes for which they are conferred."*

82. Section 172 provides:

> *"172 <u>Duty to promote the success of the company</u>*
> *(1) A director of a company must 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-*
> *(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 relationships 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.*
> *(2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.*

(3) *The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company".*

83. This codification of directors' duties has caused some concern amongst those who consider that the burden on directors will be increased. The government has tried to allay such fears:

"There is nothing in the Bill that says there is a need for a paper trail. I do not agree that the effect of passing this Bill will be that directors will be subject to a breach if they cannot demonstrate that they have considered every element" (Lord Goldsmith - Hansard col 841, 9 May 2006)

"The clause does not impose a requirement on directors to keep records ... in any circumstances in which they would not have to do so now" (Margaret Hodge - Hansard col 592 11 July 2006)

84. For the most part, the statutory duties reflect the position at common law but there is some doubt particularly as to the implications of the duty to *"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"* as this has to be understood in the context of the newly introduced concept of *"enlightened shareholder value"* which the directors need to have regard to.

85. In line with the current position, the directors will owe the codified duties to the company rather than to the shareholders as individuals. Accordingly, the references to external matters such as "*the impact of the company's operations on the community and the environment"* are (as now) likely to be ignored unless a majority of the company's members are sufficiently concerned about the directors' conduct. Such provisions are considered by many commentators to be no more than symbolic posturing on the part of the government. Perhaps directors who fail to satisfy their shareholders by creating sufficient profits will seek to hide behind such concepts as an excuse for poor performance.

86. The obligation to act in the interests of the creditors at times of insolvency continues under the Act. However, the nature of directors' obligations when a company is in the "*Twilight Zone"*, i.e. merely at risk, is not clear and has been left deliberately open by the draftsman. In the Explanatory Note to the draft Bill, it was stated that the purpose of the relevant proviso in the Bill was to recognise that the duty to promote the success of the company is displaced when the company is insolvent but that, as regards the situation when a company is nearing insolvency, the intention was to *"leave the law to develop in this area"*.

87. Section 173 imposes on directors a duty to exercise independent judgment. This may impact on nominee directors who are appointed to the board by a

particular shareholder with expectation that they will follow the shareholder's instructions. To allow for this type of situation s.173 provides that the duty is not infringed if there is appropriate authorisation in the company constitution or in an appropriate agreement with the company. It remains to be seen how a director who has the benefit of being entitled under such an agreement or the company's constitution not to exercise independent judgment will be treated by the courts when, upon instructions, he fails to make reasonable decisions. Furthermore, it is to be noted that he remains obliged to comply with the other statutory general duties, so that he cannot rely upon such a relaxation of this duty to excuse his non-compliance with the other duties (in particular to act in the way which *he* considers, in good faith, would be most likely to promote the success of the company). Presumably in the case of such an irreconcilable conflict the director will have to resign if he is to avoid being in breach of his duties to the company or to his appointor.

88. Directors continue to have a duty of skill and care. The relevant standard is set out in section 174:

"174 <u>Duty to exercise reasonable care, skill and diligence</u>

(1) A director of a company must exercise reasonable care, skill and diligence.

(2) This means the care, skill and diligence that would be exercised by a reasonably diligent person with-

(a) 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

(b) the general knowledge, skill and experience that the director has."

This standard is in line with the common law position and under s.214(4) of the Insolvency Act 1986 (eg see **Re D'Jan of London [1994] 1BCLC 561**).

89. The basic principle that directors should avoid conflicts of interest is preserved and is set out in section 175(1). The government had indicated that its intention was to relax the common law's strict rules concerning directors' conflicts of interest (see for example **Regal Hastings v Gulliver** [1967] 2AC 134. Two provisions are relevant:

* Under section 175(3), transactions or arrangements between a director and the company do not have to be authorised by either the members or by the board; instead interests in transactions or arrangements with the company must be declared under section 177 (in the case of proposed transactions) or under section 182 (in the case of existing transactions) unless an exception applies under those sections. Exceptions include Long Term Service Contracts (s.188) and Substantial Property Transfers (s.190) (eg if either over £100,000, or

over £5,000 and 10% of the companies net assets), which have their own compliance regimes;

* Section 175(5) also permits board authorisation of most conflicts of interest arising from third party dealings by the director (e.g. personal exploitation of corporate resources and opportunities). Such authorisation is effective only if the conflicted directors have not participated in the taking of the decision or if the decision would have been authorised even without the participation of the conflicted directors (s.175(6)). Board authorisation of conflicts of interest will be the default position for private companies, but public companies will need to make provision in their constitutions to permit this. Board authorisation is not permitted in respect of the acceptance of benefits from third parties (including bribes) (s. 176).

90. These are potentially important changes which will widen the scope for directors to abuse their positions. The dilution of the traditional strict rules means that there will clearly be an increased risk that:

* directors will enter into contracts with their company despite the obvious potential for conflict of interests and feel (incorrectly) that they are immune from criticism if there has been a mere declaration to the board.

* directors will improperly authorise each other's personal exploitation of corporate resources to the prejudice of shareholders.

91. Section 178 expressly provides that the consequences of directors' breaches of duty are no different to the common law or equitable principles.

CONCLUSIONS

92. Some may see the 2006 Act as a wasted opportunity to conduct a wholesale reform of Company Law.

* The benefits to smaller companies seem negligible as the administrative burden of running a company will not change significantly and it is hard to imagine that the new provisions will encourage anyone who did not previously intend to do so, to now incorporate a company.

* The measures in respect of shareholder empowerment merely tinker with the details as there was no real appetite for company management to have to answer to shareholders any more than they do already.

93. Perhaps the most common view, at least amongst practitioners, will be a

collective sigh of relief as it is anticipated that once the dust settles and the political spin is ignored it will be recognised that most of the basic and familiar company law principles have been left intact without many fundamental changes.

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