

The Companies Act 2006

October 2008 implementation update

August 2008



The Companies Act 2006 (the new Act) received Royal Assent on 8 November 2006 but is still only partially in force. This briefing looks at the key provisions being implemented on 1 October 2008 and is one in a series looking at the key implications of the new Act for companies and their directors.

Directors Conflicts and Declarations of Interest

The new Act deals with situations in which a director has an actual or potential conflict of interest with his company in three ways:

- A positive general duty for a director to avoid a conflict of interest (section 175). This general duty does not apply to a conflict of interest arising in respect of a transaction or arrangement with the company.
- A duty not to accept benefits from third parties (section 176).
- A duty to declare interests a director has in a proposed or existing transaction or arrangement with the company (sections 177 and 182).

Common to all three situations is a general underlying principle - there is no breach of the duty or obligation to disclose if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest. This sounds simple in theory but may be more difficult to apply with certainty in practice. A prudent approach is recommended.

Section 175 – the new, positive duty to avoid a conflict

This duty imposes a broad, general requirement to avoid a situation in which a director has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company. It applies to the exploitation of any property, information or opportunity regardless of whether the company could have taken advantage of it.

What is a section 175 conflict?

There is no definition of conflict of interest under the new Act and it is not possible to set down a hard and fast rule of what situations will or will not amount (or potentially) amount to a conflict of interest under the broad general duty. The following are examples of arrangements which may potentially need authorisation:

- **multiple directorships** - a director is also on the board of a major shareholder, the company's pension scheme, a competitor or a customer or supplier of the company
- **personal interests** – a director is himself a major shareholder, a competitor, a customer or supplier of the company or owns property adjacent to the company's property which could be affected by the company's activities
- **advisory positions** – a director has another hat as an advisor to the company (eg lawyer or accountant) or to a competitor of the company
- **other profits** – a director makes personal use of the company's information or opportunities, wants to take up an opportunity declined by the company or is in any situation where he can make a profit as a result of his directorship
- **connected persons** – if any of the above situations apply to a person connected with the director, eg spouse, partner, parent, child or other close family member

Burges Salmon LLP, Narrow Quay House, Narrow Quay, Bristol BS1 4AH
Tel: +44 (0) 117 939 2000 Fax: +44 (0) 117 902 4400
Chancery Exchange, 10 Furnival Street, London EC4A 1AB
Tel: +44 (0) 20 7685 1200 Fax: +44 (0) 20 7685 1266
www.burges-salmon.com



Burges Salmon LLP is a Limited Liability Partnership registered in England and Wales (LLP number OC307212) and is regulated by the Solicitors Regulation Authority. A list of members, all of whom are solicitors, may be inspected at our registered office: Narrow Quay House, Narrow Quay, Bristol BS1 4AH.

It is not entirely clear how (if at all) this new codified duty changes the underlying principles of law relating to conflicts as directors have always been subject to a fiduciary no-conflicts rule. As with the other codified directors' duties implemented in October 2007, the new Act states that the duty must be interpreted and applied in the same way as the common law and fiduciary duties on which it is based. What is clear however is that the new Act now places a positive duty on a director not to allow a conflict of interest situation to arise in the first place. On the flip side, it introduces a flexibility that has not previously existed – board authorisation.

Whilst this duty appears on its face to be quite restrictive there are a number of relaxations built into the new Act which should allow companies and directors to comply with the new regime without, in most cases, fundamentally changing their behaviour (other than in an administrative manner):

- there is no breach of duty if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest - on a proper analysis will there actually be a conflict or potential for a conflict with the interests of the company?
- the directors may be given the power to authorise a conflict or potential conflict of interest. Board approval allows for a simpler authorisation process than shareholder approval.
- the scope for safe-harbour provisions in the company's articles – see below.

Key points

- Public companies - the directors' authorisation route will only be available for public companies if their articles expressly give the directors the permission to authorise conflicts – see *Authorisation flowchart* on page 4.
- Private companies - the articles do not need to expressly allow the directors to authorise conflicts however they must not contain anything which would invalidate such an authority. Under the commencement regulations, private companies incorporated before 1 October 2008 must pass an ordinary resolution allowing the directors to authorise conflicts – see *Authorisation flowchart* on page 4.
- The Board should consider carefully the specifics of each conflict situation referred for authorisation – see *Board Consideration* on the *Authorisation flowchart* on page 4.
- Companies will need to put in place good procedures for dealing with conflicts of interest – see *Good Procedures* on the *Authorisation flowchart* on page 4.
- Authorisation by the board approves the conflict of interest situation but does not absolve a director from his other general duties to the company, for example the duty of confidentiality and duty to act in good faith to promote the success of the company. The new Act allows the articles of association to contain provisions relating to conflicts and states that anything done in accordance with these provisions will not be a breach of the directors' general duties. These so-called safe-harbour provisions may be used to both clarify how the director is expected to conduct himself in relation to an authorised conflict and also to confirm that he will not be in breach of duty by acting in that manner – see *Conflict Management Provisions* opposite.
- Both public and private companies may wish to consider including specific provisions in their articles dealing with the procedure for management of authorised conflicts – see *Conflict Management Provisions* opposite.
- The concept of an indirect conflict means that the scope for potential conflict situations caught under the duty is broad enough to include persons connected with the director. For example, the position of a spouse or partner, parent or child or other company which the director is a director or shareholder of will also need to be considered when looking at what the director needs to do to comply with the new Act.
- Authorisation by the board is forward looking and cannot be retrospective. What is the position then with conflicts which existed before 1 October 2008? The new Act applies where the conflict situation arises on or after 1 October 2008. Conflict situations arising before that date are, strictly speaking, not caught by the new Act. However every situation has the potential to change (for example, a potential conflict may develop into an actual conflict at a later date) giving scope for uncertainty as to what was an existing conflict situation. A cautious approach should be taken – for existing conflict situations which will continue after 1 October 2008 it will be prudent to arrange board authorisation with effect from that date.

- This duty does not apply to a conflict of interest arising in relation to a transaction or arrangement with the company. Potential conflicts of interest of that nature are dealt with by way of disclosure in accordance with sections 177 and 182 (see below). However, whilst those sections deal with the transactions between the company and the director or a third party with which the director may be connected (for example, as a director of another company) the actual underlying relationship between the director and that third party may in itself give rise to a potential conflict of interest under the general duty. The prudent approach would be to also ensure the underlying relationship is authorised by the board under section 175.
- The GC100 has published (January 2008) a detailed guidance paper on directors' conflicts of interests which is aimed at listed companies but is helpful reading to companies of all sizes. The paper, reviewed by the ABI, explains the changes which companies may wish to make to their articles and provides guidance for directors on the practicalities of exercising their power to authorise conflicts. In August the GC100 also published a pack of concise documents (including a checklist for company secretaries and a briefing note and questionnaire for directors) aimed at helping companies identify conflicts and comply with the new regime. These papers are available via the Practical Company Law website at <http://www.practicallaw.com/6-378-7923>.

Section 175 - Conflict Management Provisions

A company may want to set out in its articles provisions dealing with the management of authorised conflicts, including:

- the procedure for board authorisation including quorum requirements
- safe harbour provisions - setting out a director's conduct in relation to an authorised conflict and confirming that a director will not be in breach of his duties to the company in respect of that conduct, for example:
 - a director is not required to disclose to the company confidential information received from a third party as a result of an authorised conflict if that would amount to a breach of his duty to a third party
 - a director is permitted to absent himself (or is excluded) from a board meeting and from receiving board papers relating to a matter connected with an authorised conflict
 - a director is not required to account to the company for any benefit he receives as a result of the authorised conflict
- re-emphasising the director's duty to keep the company's information confidential
- possibly setting out limited situations where a director is permitted to put himself in a potential conflict situation without requiring board authorisation, eg cross-directorships of group companies.

Companies will want to ensure that any conflict management provisions in the articles give the board flexibility to impose specific conditions and limitations on each individual authorisation considered, where appropriate.

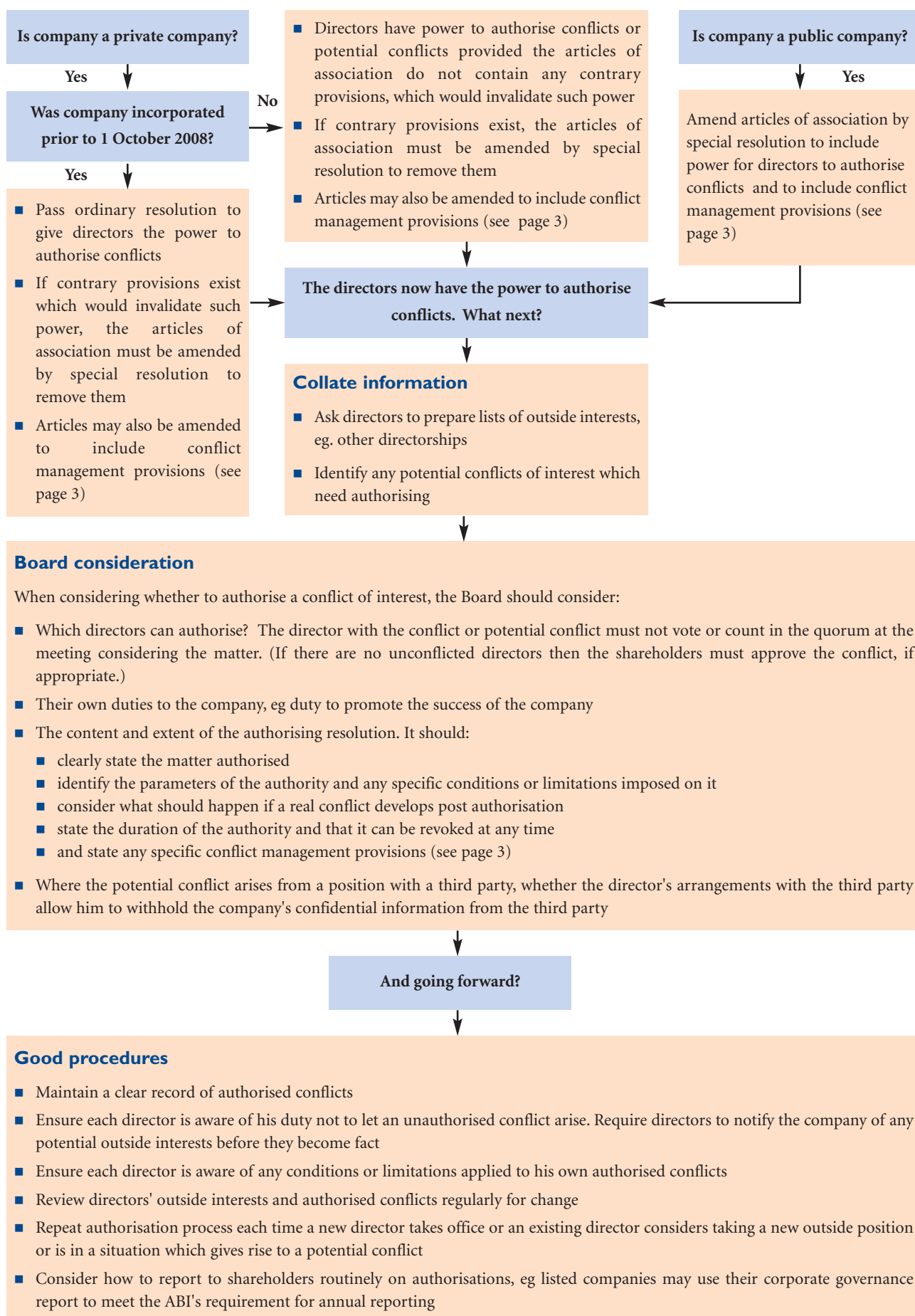
Section 176 – the duty not to accept benefits from third parties

A director must not accept a benefit from a third party given to him because he is a director or because of anything he does or does not do as a director.

Key points

- Again, this duty is not breached if acceptance of the benefit cannot reasonably be likely to give rise to a conflict of interest. Companies may find it useful to issue or update board guidance on what they consider will be likely to give rise to a conflict of interest.
- A breach cannot be avoided by board authorisation (unlike the general conflict duty under section 175).
- Group companies are not counted as third parties.

Section 175 - Authorisation flowchart



Sections 177 and 182 – the duties to disclose interests in transactions with the company

If a director is directly or indirectly interested in a transaction or proposed transaction or arrangement with the company he must declare the nature and extent of his interest to the board. Section 177 deals with proposed transactions and arrangements with the company and section 182 with transactions or arrangements that have already been entered into by the company. These duties are substantially the same as the current disclosure obligations under the Companies Act 1985 and will not lead to any significant change in practice.

The key changes to the disclosure requirements under the new Act are:

- The old requirement to disclose the nature of an interest has been extended to disclosure of the nature and extent of the interest, for example it will no longer be sufficient for a director to disclose that he is interested in a transaction by virtue of being a shareholder in a third party company – he is now obliged to declare the size of his shareholding.
- There is an updating obligation which requires the director to make a further declaration if any previous declaration becomes inaccurate or incomplete, for example this could catch an increase in shareholding in the third party example above.

Key points

- These are disclosure obligations only – unlike the general conflict of interest duty in section 175 (which, as a reminder does not apply to transactions or arrangements with the company) there is no requirement for board authorisation of the interests.
- If an interest has been disclosed under the current regime before 1 October 2008 then it will not need to be disclosed again when the new Act comes into force unless, or until, there is a change in the nature or extent of the interest.
- Due to the updating requirement, it becomes increasingly important to have good procedures in place to record and regularly review directors interests in arrangements with the company. Directors should be made aware (and reminded on a regular basis) of their obligations to disclose not only interests but also any change in the nature or extent of those interests and to do this as soon as they are aware of the interest.
- Disclosure of interests can continue to be made at a board meeting (including by way of a general notice that the director has an interest in a particular third party company or person and is to be taken as interested in any transaction between the company and that third party). Disclosure of an interest in a specific transaction or proposed transaction can also be made by way of notice in writing to the board. The new Act has clarified that interests in proposed transactions must be disclosed before the company enters into the transaction.
- A director need not declare an interest:
 - (As with the other conflict-related duties) if it cannot reasonably be likely to give rise to a conflict of interest.
 - In his own service contract (the new Act now expressly excludes the requirement to disclose in this case).
 - Where the director is not aware of either his interest or the transaction in question (if he ought reasonably to be aware then he will be deemed to be aware).
 - If the other directors are already aware (or ought reasonably to be aware) of it. For example, the board may have given section 175 authorisation to a director allowing him to be a director of another company with which (at that time) it had no trading relationship. At a later date a relationship may develop and the company may enter into a contract with that other company. Arguably as the board has authorised the original conflict and should be aware of his position as director of the other company it may not be necessary for the director to disclose his interest in the transaction. The prudent approach would seem to be for a director to give a general notice of his interest in the other company and any transactions it may enter into with the company at the same time he seeks authorisation under section 175. Any restrictions or conditions on the section 175 authority would need to be considered (see **Board Consideration** in the **Authorisation flowchart** opposite).
 - Again, the concept of an indirect interest means that the scope of the disclosure requirements is broad enough to include persons connected with the director. The position of a spouse or partner, parent or child or other company which the director is a director or shareholder will also need to be considered when looking at what the director needs to do to comply.

Private Company Financial Assistance

Currently neither public or private companies (or their subsidiaries) may give financial assistance to any person for the purchase of the company's shares. Financial assistance can take many forms including the giving of a loan, gift, guarantee or security over assets. In the context of private company transactions it can create a seemingly unnecessary obstacle, lead to complicated deal-structures and/or leave companies with a hefty bill for advisory fees. The implications of getting it wrong have ensured that companies try hard to get it right - potential penalties for breach of the current regime are fines (for both the company and directors) and also criminal liability for the directors.

With effect from 1 October 2008, the restriction on the giving of financial assistance by a private company will be removed in one of the key deregulatory moves of the new Act. The rules remain unchanged for public companies. This is good news for private companies and should save them both time and costs in their transactions. However, with the removal of the restriction on financial assistance, the relaxation for private companies known as the "whitewash" will no longer be needed and will also be removed from the statute books. The whitewash basically involves board approval, shareholder approval and most importantly (and expensively) statutory declarations of solvency sworn by all directors supported by an auditors report. Whilst costly and time-consuming the whitewash serves three practical purposes:

- subject to a net asset condition, it provides private companies with a route to give the financial assistance needed to get their deal done
- by following the statutory procedure, directors get a certain degree of comfort that they are acting in a proper manner
- in the typical leveraged transaction, it provides lenders with comfort that a company and its directors have carefully considered the transaction and its implications.

With the removal of the whitewash, the comforts mentioned above will no longer be gained via a neat, obligatory statutory package but will be none the less necessary. Even after the prohibition on financial assistance has been removed private companies and their directors will still need to carefully consider any proposed financial assistance in the context of:

- Corporate benefit/directors duties – what is the commercial benefit to the company and how does this fit with the directors' statutory duty to act in a way they consider in good faith to be likely to promote the success of the company for the benefit of the members as a whole?
- Unlawful distributions/reductions of capital – does the financial assistance amount to an unlawful distribution or dividend to members or any other unlawful reduction of capital?
- Insolvency – could the financial assistance be challenged in the event of insolvency?

There remains uncertainty as to what comfort lenders will require about the solvency of the company to replace that provided by the statutory whitewash procedure and as yet it is impossible to identify what will become industry practice. It is likely however this will involve:

- Detailed board minutes, setting out why the relevant financial assistance is regarded as "most likely to promote the success of the company for the benefit of its members as a whole" together with a risk/reward assessment in respect of the financial assistance.
- Where there is any doubt as to the commercial benefit of the assistance, lenders are likely to require that the company obtains shareholder approval.
- Lenders may require increased financial and legal due diligence to satisfy themselves that proper consideration has been given to the issues listed above.
- It is possible that in certain circumstances where there are concerns over solvency, lenders may insist on some form of comfort from auditors – hopefully, given the cost implications, this will be limited to situations where an independent auditor's view is really necessary to give both lenders and directors comfort and will not become standard practice for all financial assistance.

Private Company Reduction of Capital

From 1 October 2008, a new procedure to enable private companies to reduce their share capital without following the traditional court procedure will be introduced. The new Act will allow a private company to reduce its capital by way of special resolution supported by a solvency statement.

The court approved procedure for a share capital reduction for both public and private companies found in the Companies Act 1985 will remain in force until October 2009, when it will be replaced with almost identical provisions in the new Act.

Key points

- A private company following the new procedure will need to pass a special resolution supported by a solvency statement (made not more than 15 days before the passing of the resolution).
- The solvency statement must be signed by each of the directors and must state that they have formed the opinion that:
 - at the date of the statement there is no ground on which the company could be found unable to pay its debts
 - if it is intended to commence winding up of the company within 12 months of the date of the statement, that the company will be able to pay its debts in full within 12 months of the commencement of winding up
 - in all other cases, the company will be able to pay its debts as they fall due during the 12 months following the statement.
- When forming their opinion, the directors must take account of all of the company's liabilities (including contingent or prospective liabilities). Whilst there is no statutory requirement for the directors to draw up accounts or a balance sheet of the company to support the statement, the board may find this a useful and prudent process for forming their opinion and also as evidence of due consideration of the issues in the context of their directors' duties.
- The resolution, solvency statement and a statement of capital must be filed at Companies House within 15 days of the passing of the resolution. The resolution (and the reduction) will not take effect until these documents are filed.
- It will be a criminal offence for the directors to make a solvency statement and file it at Companies House without having reasonable grounds for the opinion expressed in it. The offence will be punishable by a fine and/or up to two years imprisonment.
- Regulations made under the new Act confirm that, subject to certain exceptions, a reserve arising from a capital reduction, whether under the existing court procedure or (for private companies only) the new directors' solvency statement procedure, may be treated as a realised profit for the purposes of calculating whether a company can pay a dividend. Private companies may now have (in the form of the solvency statement procedure) a less expensive option to remove accumulated losses and unlock dividend blocks.

Other key provisions being implemented on 1 October 2008

- Trading disclosures – (largely restating the current rules) rules regarding the disclosure of the company's registered name and other particulars at stated locations, in correspondence and documentation (including emails) and on websites. The DBERR has published a number of useful FAQs relating to this topic, available at <http://www.berr.gov.uk/bbf/co-act-2006/faq%20Act%202006/page38501.html>.
- Companies must have at least one director who is a natural person – if a company had no directors who were natural persons on 8th November 2006 (Royal Assent of the new Act) then a grace period applies. Those companies will have until 1 October 2010 to make the appropriate changes to their internal structures to comply.
- A director must be at least 16 years old – existing under-age directors will automatically cease to hold office on 1 October 2008.

continued overleaf

Other key provisions being implemented on 1 October 2008 *continued*

- Annual returns – as an interim measure amendments will be made to the Companies Act 1985 relating to disclosure of shareholder details in annual returns (pending introduction of similar provisions under the new Act in October 2009). These new rules will apply to annual returns made up to dates on or after 1 October 2008 and provide that:
 - public companies traded on a regulated market (which includes the Official List of the London Stock Exchange but not AIM) must provide names, addresses and shareholdings of members who hold 5% or more of any class of shares at any time during the relevant year
 - other public companies and private companies need only provide the names and shareholdings (but not addresses) of all members.

Further information

For further information please speak to your usual contact at Burges Salmon or contact **Nick Graves** (0117 939 2200) (nick.graves@burges-salmon.com) (Partner) or **Alyson Whale** (0117 939 2294) (alyson.whale@burges-salmon.com) (Professional Support Lawyer).

Companies Act 2006 briefings

Key briefings in this series available on our website at

http://www.burges-salmon.co.uk/what_we_do/Practices/corporate/Publications/default.aspx

Companies Act 2006 – An Overview (published February 2007)

Companies Act 2006 – What does it mean for Directors? (published February 2007)

Companies Act 2006 – What does it mean for private companies? (published March 2007)

Companies Act 2006 – What does it mean for public companies? (published March 2007)

Companies Act 2006 – provisions coming into force on 1 October 2007 (published September 2007)

Companies Act 2006 – April 2008 implementation and Articles of Association update (published March 2008)

Disclaimer: This briefing gives general information only and is not intended to be an exhaustive statement of the law. Although we have taken care over the information, you should not rely on it as legal advice. We do not accept any liability to anyone who does rely on its content.

© Burges Salmon LLP 2008. All rights reserved. Extracts may be reproduced with our prior consent, provided that the source is acknowledged.

Data Protection: Your details are processed and kept securely in accordance with the Data Protection Act 1998. We may use your personal information to send information to you about our products and services, newsletters and legal updates; to invite you to our training seminars and other events; and for analysis including generation of marketing reports. To help us keep our database up to date, please let us know if your contact details change or if you do not want to receive any further marketing material by contacting marketing@burges-salmon.com.