Companies Act 2006

Directors’ Duties, Derivative Actions and Other Miscellaneous Provisions

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DIRECTORS — DUTIES

1. Codification of Directors’ Duties

The Act codifies directors’ duties with a view to reflecting in statute the common law position, but with some significant changes. The main reason given for codifying directors’ duties is to provide an authoritative statement of what those duties are. However, the critics of codification point to the lack of flexibility which it provides and uncertainties over the relationship between the new statutory code and the pre-existing common law. These uncertainties arise due to the fact that the Act states that the statutory duties replace the common law duties, but also provides that common law rules and equitable principles will apply in interpreting the statutory duties. Where the language in which the statutory duty is expressed differs from the language in which the corresponding common law duty was expressed by judges, it is not clear how this interpretation provision will be applied.

The Act provides that directors owe the following duties:

> to act in accordance with the company’s constitution and for proper purposes;
> to promote the success of the company;
> to exercise independent judgement;
> to exercise reasonable care, skill and diligence;
> to avoid conflicts of interest;
> not to accept benefits from third parties; and
> to declare interests in proposed transactions and arrangements.

The above statement of duties does not cover all of the duties a director may owe to a company, for example the duty to consider the interests of creditors in times of threatened insolvency.

The majority of these provisions (the first four duties listed above) will be brought into force on 1 October 2007. Companies should check their D&O policy before that date to ensure that it provides cover in respect of the codified duties and derivative actions (for example, that there is no major shareholders exclusion). The other three duties, relating to directors’ conflicts of interest, will come into force in October 2008.

2. Duty to Promote Success of the Company (“Enlightened Shareholder Value”)

The statutory duty which has generated the most debate is the duty of directors to promote the success of the company. This duty requires a director 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” (section 172 of the Act). The Government has stated that “success” in this context would usually mean “long-term increase in value” where commercial companies are
concerned. However, it will be open to a company to adopt a different definition of “success” in its constitution. According to the Government, the decision as to what will promote the success of a company is ultimately one for the good faith judgment of the directors.

Under section 172 of the Act a director, in fulfilling his duty to promote the success of the company, is to have regard (amongst other matters) to:

> the long term consequences of any decision;
> the interests of the company’s employees;
> the need to foster business relationships with suppliers, customers and others;
> the impact of the company’s operations on the community and the environment;
> the desirability of the company maintaining a reputation for high standards of business conduct; and
> the need to act fairly as between members.

This provision has given rise to the concern that directors will be exposed to increased litigation risk, particularly in view of the new statutory provisions allowing shareholders to commence derivative claims against directors on behalf of the company in certain circumstances (see further below). This section should not, however, permit third parties (such as employees) to bring claims against directors for failure to consider the statutory factors. There is also an expectation that the enhanced content requirements for the business review will allow a greater level of shareholder scrutiny over company policies. Indeed, one of the stated purposes of the review is to enable the shareholders to assess how the directors have performed their duty to promote the success of the company.

It is clear that a director is only obliged to have regard to the factors listed above and is not required actively to promote the interests of the environment, the community and so forth. In addition, a director continues to owe his duties solely to the company, (except in limited cases) not to the third parties whose interests they have to consider, such as employees, suppliers and local communities. However, directors now have to be in the position that if challenged they will be able to satisfy third parties (and possibly the Court) that they did have regard to the above matters (and any other applicable matters) when making decisions affecting the company. This will be the case for directors of all companies (whether a listed plc, private company or a subsidiary within a large group) making decisions in board meetings and meetings of delegated committees down to an executive director making decisions on behalf of the company (for example choosing one contractor over another).

Companies therefore need to decide what policies to put in place to ensure that directors fulfil their statutory duties while not hampering the decision-making process by unnecessary bureaucracy.
Does the board need explicitly to consider each section 172 factor? Is there a need for a paper-trail?

There will be many matters which come for consideration by the board or a director where some of the section 172 factors are irrelevant. For example, does the board need to consider the environmental repercussions of a bond issue? In our opinion, there is no need for the board to consider each section 172 factor expressly, regardless of its relevance to the matter under consideration.

There is a separate question regarding the extent to which it is prudent to record more detail of the board’s consideration of the various factors. Many company secretaries and corporate legal counsel are concerned that the new legislation will give rise to the unnecessary reworking and extension of board minutes as a pure defensive reaction and so hamper the dynamic decision making process. Even if intuitively directors discount some or many of the factors listed above as being irrelevant, directors will need to have in mind the section 172 factors (together with any other relevant factors) when making decisions. While company secretaries will continue to have to exercise discretion as to what particular matters should be minuted as having received attention, expansion of the board minutes for record purposes without reflecting the actual decision process would not be desirable.

It may be considered appropriate to remind directors at the time of the list of factors to which (amongst other things) they must have regard when making decisions and to reflect in board minutes, by way of a standard minute, simply the fact that this reminder took place (similar to the form of section 317 minute which is now so familiar). However, it is for company secretaries (and/or legal advisers) to determine whether this is necessary and to exercise discretion as to any specific matters that need to be recorded in minutes, only doing so where it is necessary given their importance to the matter at hand.

Since not all board decisions will be formally minuted and many decisions affecting a company will be taken by a sole director in less formal circumstances than a board meeting, it will also be important that all directors of all companies should be briefed on the importance of considering the listed factors when making decisions. In addition, management when preparing board papers for directors to review should be encouraged to highlight the importance of considering each of the factors where relevant and include relevant commentary on them in the board papers.

**Procedures**

All companies should ensure that all board members are aware of their duties under the new Act and that company policies should reflect the listed factors. The general counsel of some of the UK’s largest companies (GC100) recommend that this can be done in all or some of the following ways, which we support:

> as a transitional move, boards should be given a thorough briefing on the new duties introduced by the Act;
on appointment, all new directors should be briefed upon their duties under the Act;

> the terms of appointment and description of the role of any director should specifically refer to their duties;

> the terms of reference of any board or committee may also refer to those duties; and

> companies should review their existing policies in areas such as human resources, ethics, compliance and corporate responsibility against the background of the new duties.

In addition to the above, we suggest:

(i) the company should ensure that management and those responsible for preparing board papers are also given a thorough briefing on the new duties of directors; and

(ii) when the board reviews the strategy of the company, care is taken to ensure that the relevant factors are considered and taken into account in deciding the strategy to be adopted.

Some companies may adopt a policy of circulating a short summary of the directors’ duties with board papers.

3. Duty to exercise Reasonable Care, Skill and Diligence

A director must exercise the care, skill and diligence which would be exercised by a reasonably diligent person with both the general knowledge, skill and experience that may be reasonably expected of a person carrying out the functions carried out by the director in relation to the company (the objective test) and the general knowledge, skill and experience that the director actually has (the subjective test) (section 174 of the Act).

The practical consequences of the objective and subjective limbs of this duty include the following:

> a member of the audit committee would be expected to exercise greater diligence in relation to the accounts;

> the CEO and finance director of a company would be likely to be held to have to meet a higher standard than a non-executive director; and

> a director who is a qualified accountant would be expected, where this superior knowledge and skill was applicable, to show a higher standard of skill, care and diligence than a director without such qualifications.
4. Conflicts of Interest and Benefits from Third Parties

**Duty to Avoid Conflicts of Interest**

A director “must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company” (section 175 of the Act). This duty does not apply to transactions to which the company is or will be a party. The duty is not infringed if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest, or if the matter is authorised by the board of directors. Directors’ authorisation may be given in a private company where the constitution does not invalidate the authorisation or in a public company where the constitution allows the directors to do so. Note that this is a change to the current law which requires shareholders to approve any such conflict, whether by provision in the Articles of Association or by resolution.

**Duty to Declare an Interest in Transactions**

Section 177 of the Act provides that if a director has any direct or indirect interest in any proposed transaction or arrangement with the company, he will have a duty to declare both the nature and the extent of that interest to the other directors. Section 182 contains a similar duty to declare an interest in a transaction or arrangement that has been entered into by the company although the consequences of failure to declare the interest would be that the director committed a criminal offence.

Please refer to the section on declaration of interest by directors below for more detail of the changes in this area of the law.

**Duty not to accept Benefits from Third Parties**

Section 176 of the Act imposes a duty on a director not to accept benefits from third parties which are conferred because of their directorship or their acts or omissions as a director. This duty is limited in the same way as the duty to avoid conflicts of interest: it is not infringed if acceptance of the benefit “cannot reasonably be regarded as likely to give rise to a conflict of interest”. It should be noted that there is no de minimis threshold for this duty.

**Commencement**

The provisions relating to directors’ conflict of interest duties set out in sections 175, 176 and 177 of the Act, together with sections 182 to 187 of the Act, will not take effect until October 2008, in order to give companies the opportunity to change their Articles of Association before the commencement of these provisions.
5. **Director’s declaration of interest**

The Act imposes a duty on directors to declare both the nature and extent of their interest in any transactions which have been proposed but not yet entered into by the company, as well as in any transactions which the company has already entered into. In cases of a proposed transaction, the relevant director must do so *before* the transaction or arrangement is entered into, rather than at the first meeting at which the transaction or arrangement is discussed (as is currently the law). Directors need not, however, declare an interest if it cannot reasonably be regarded as likely to give rise to a conflict of interest. As noted above, these new rules will come into force in October 2008.

A failure by a director to declare his interest in an existing transaction will result in the director having committed a criminal offence. Upon conviction, the director will be liable to a fine.

The declaration may be made in one of three ways: at a board meeting, by notice in writing or by general notice. In the event that the notice is made in writing, it may be sent in electronic form (if the other directors have agreed to receive it in that form). Once a notice in writing has been sent, such notice is deemed to form part of the proceedings of the next board meeting and so should form part of the minutes of that meeting (a change from the current statute and practice).

A director need not declare his interest where: (i) if it cannot reasonably be regarded to give rise to a conflict of interest; (ii) if the other directors are already aware of it; and (iii) if it concerns the terms of his service contract which is either to be considered by a meeting of the directors or by a committee of directors appointed for that purpose under the company’s constitution.
DERIVATIVE ACTIONS

Derivative claims and proceedings by members in England and Wales

The new provisions on derivative claims have been one of the most hotly debated aspects of the Act. The Act adopts the recommendation of the Law Commission that derivative claims should be placed on a statutory footing and involve a “new derivative procedure with more modern, flexible and accessible criteria for determining whether a shareholder can pursue an action”.

Derivative claims under the existing common law regime are rarely pursued and it is thought that, at least in the private company context, derivative claims will remain highly unusual. Since the remedy for a derivative action is in favour of the company, it is expected that shareholders will continue to prefer an action for unfair prejudice (see below) which provides a buy out remedy for individual shareholders. However, there is a risk that in the public company sphere, derivative actions may be used as a tactical measure.

1. Current law

Currently, the ability of a shareholder to bring a derivative claim (that is, a claim made by a shareholder in the name of, and for the benefit of, his company) is governed by common law under what is known as the rule in *Foss v Harbottle*. The effect of the rule is that a minority shareholder cannot sue for wrongs done to his company or complain of irregularities in its internal affairs. However, there are certain exceptions to the rule, including where:

- the company is controlled by the wrongdoers in a particular situation and this control could lead to a fraud on the minority shareholders; or

- an ultra vires or illegal act has occurred which cannot be ratified or confirmed by the company.

In these circumstances, a minority shareholder could seek to bring a derivative action on behalf of the company.

The common law in this area is considered to be complex and derivative claims by shareholders are relatively rare.

2. The new provisions

Timing

The new provisions on derivative claims in England and Wales and Northern Ireland are contained in sections 260 – 264, set out in Chapter 1 of Part 11 of the Act. These provisions will come into force on 1 October 2007. Chapter 2 of Part 11 separately sets out provisions on derivative claims in Scotland. The DTI has been consulting on whether to make transitional provisions in relation to derivative claims.
**Definition of derivative claims**

A derivative claim is defined under Chapter 1 of Part 11 of the Act as being proceedings in England and Wales or Northern Ireland:

> 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.

The person bringing the claim must be a member of the company at the time he brings the claim. He does not need to have been a member at the time the cause of action arose. This has led to concerns that someone wanting to challenge a company’s actions could buy shares in the company after the event, merely for the purposes of bringing a claim. However, this is in line with the current position at common law and makes sense from the point of view of the cause of action being vested in the company rather than in the shareholder bringing the claim.

Once the new provisions are in force, a derivative claim may only be brought in England and Wales under Chapter 1 of Part 11 or pursuant to a court order in proceedings for protection of members against unfair prejudice (the statutory procedure under the Act equivalent to what is currently contained in section 459 Companies Act 1985).

**Scope of claims**

A derivative claim may be brought for 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 (including former directors and shadow directors). This will cover an alleged breach of any of the general duties of directors which are discussed above (the duties set out in Chapter 2 of Part 10 of the Act). The claim may be brought against a third party and/or against the relevant director himself.

There is concern that this will give increased scope for derivative claims for the following reasons:

> the breadth of the new general duties of directors (see ‘Directors – Duties’, above);

> there will be no requirement for the director to have benefited personally from the breach, as is the case under the current law;

> it will no longer be necessary for the shareholder bringing the claim to show that the directors who carried out the wrongdoing control the majority of the company’s shares (the so-called "wrongdoer control" test under the current law), and

> the ability to bring derivative claims against third parties (although the DTI’s explanatory notes to the Act suggest that derivative claims against third parties would be permitted only in very narrow circumstances, for example where a third party knowingly received a company’s money or property from a director acting in breach of trust).
Procedure for bringing claims

There is no need for a shareholder to obtain permission prior to issuing a claim form for a derivative claim, but the Act sets out a two-stage procedure for seeking the court’s permission to continue the claim once he has commenced proceedings. In addition, the Act sets out specific factors to be considered by the court in determining whether to grant such permission (see ‘Factors for courts to take into account when considering applications for permission to continue claims’, below). The claim will progress to a full trial of the issues only if the shareholder is successful in both of the first two stages.

> Application for permission to continue a derivative claim - the first stage: The shareholder bringing the claim must apply to the court for permission to continue the claim and provide evidence to the court to make out a prima facie case for obtaining that permission. If the court determines that a prima facie case is not made, it must dismiss the application and may make any consequential order that it considers appropriate (such as a costs order or a civil restraint order against the shareholder). Neither the defendants nor the company itself are involved at this stage although the company will have received notice of the claim. The Government sees this as an opportunity for the courts to dismiss vexatious or unmeritorious claims as early as possible in the process.

> Application for permission to continue a derivative claim - the second stage: If the application is not dismissed by the court at the first stage, the court may then direct the company to provide evidence and, on hearing the application, may grant permission for the shareholder to continue the claim on whatever terms the court thinks fit, may adjourn proceedings and make such directions as it thinks fit or may refuse permission and dismiss the claim.

The requirement in the Act that a shareholder obtain the court’s permission to continue a derivative action reflects the current procedure under Part 19 of the Civil Procedure Rules. However, the two-stage test and the specific factors which the Act requires the court to consider (which are discussed below) are new.

As well ascommencing a derivative claim himself, a shareholder may in certain circumstances continue as a derivative claim a claim brought by the company or continue a derivative claim brought by another shareholder. The permission of the court is required in either case and the two stage procedure referred to above applies. A shareholder may apply for permission to continue a claim brought by the company or by another shareholder if:

> the manner in which the company or the other shareholder has commenced or continued the claim amounts to an abuse of the process of the court;

> the company or the other shareholder has failed to prosecute the claim diligently (the Solicitor-General has suggested that this means a failure to pursue the claim in a reasonable way without undue delay that would have the effect of frustrating somebody else’s ability to bring a claim); and
it is appropriate for the shareholder to continue the claim as a derivative claim (for example, if the other shareholder has fallen ill).

Factors for courts to take into account when considering applications for permission to continue claims

The Act sets out certain circumstances in which the court must refuse permission for a shareholder to continue a derivative claim (whether he has brought the claim himself or he is applying to continue as a derivative claim a claim brought by the company), as well as criteria that the court must take into account in reaching its decision in any other case. The Secretary of State (after consulting such persons as he considers appropriate) is given power to make regulations to amend or add to both the list of bars to giving permission and the list of criteria to be taken into account.

Bars to the giving of permission to continue a derivative claim: A court must refuse permission to continue a claim if it is satisfied that:

- a person acting in accordance with the general duty of a director to promote the success of the company would not seek to continue the claim; or

- the cause of action arises from an act or omission (whether or not the act or omission has yet taken place) which was authorised by the company in advance or has been ratified by the company after its occurrence.

Criteria to take into account when considering whether to give permission to continue a derivative claim: In considering whether to grant permission to continue a claim, the court is required to take into account, in particular, the following criteria:

- whether the shareholder is acting in good faith in seeking to continue the claim;

- the importance that would be attached to continuing the claim by a person acting in accordance with the general duty of a director to promote the success of the company;

- whether the act or omission from which the claim arises (whether or not the act or omission has yet taken place) has been, or in the circumstances would be likely to be, authorised by the company in advance or ratified by the company after its occurrence;

- whether the company has decided not to pursue the claim;

- whether the act or omission from which the claim arises gives rise to a cause of action that the shareholder could pursue in his own right rather than on behalf of the company; and

- any evidence before the court as to the views of shareholders of the company who have no personal interest, direct or indirect, in the matter.
Particular points to note in relation to these factors include the following:

> **Conduct promoting the success of the company**: In practice it will effectively be left up to the court to determine what amounts to conduct which promotes the success of the company, although any evidence provided by the directors themselves will no doubt be relevant. This will therefore require the court to consider the likely commercial consequences for the company of continuing the claim.

> **Ratification**: A claim will be barred in respect of a matter which has been ratified by shareholders but, short of ratification having taken place, the court must consider the likelihood in practice of ratification taking place as well as whether the matter is capable of ratification. It will therefore be possible for the court, if it considers it appropriate, to permit a claim to continue in respect of a matter which is capable of ratification, which represents an extension of the common law position. In practice, this may encourage companies to put ratification resolutions to shareholders more frequently than they would have done otherwise, which could be administratively burdensome. The procedure for ratification will be subject to section 239 of the Act. The votes of directors whose acts are the subject of the resolution (and the votes of any connected persons) will therefore be discounted (see ‘Directors – Liabilities’, above).

> **Views of disinterested shareholders**: The requirement to consider the views of disinterested shareholders may be seen as importing to some extent the common law principle under the rule in *Foss v Harbottle* that a minority shareholder should not be able bring a claim against the general wishes of shareholders. In practice this might encourage companies to approach institutional shareholders for support in the face of claims by activist shareholders.

> **Relative importance of criteria**: Although the Act lists specific criteria for the courts to take into account when considering whether to give permission for a derivative claim to proceed, no guidance is given as to the relative weight that should be attributed to those criteria.

3. **Rights of members to access company documents in derivative actions**

Generally, a shareholder does not have the ability to call for board minutes or board papers since the Articles of Association of most companies deny members of the company general access to the books or records of the company unless authorised to do so by the directors or by law. The *Companies Act 1985* (the “*1985 Act*”) does not give members a right to inspect board minutes or board papers and the 2006 Act has not amended this position.

The Civil Procedure Rules do provide, however, a mechanism for a claimant to gain access to a company’s documents to assess the basis for and merits of commencing a derivative action and thereafter to support an application to continue such proceedings. Further, once leave has been granted by the court to continue a derivative action, the standard disclosure rules for civil proceedings apply. Note also that the normal rules of privilege do not apply as against shareholder claimants to prevent production of privileged documents unless the documents in question were obtained by the company in contemplation of litigation against the company of the kind in relation to which their disclosure is being sought.
4. Conclusion

Considerable concern was expressed during the passage of the Companies Bill through Parliament that the new provisions on derivative claims, coupled with the codification of directors’ duties, would encourage shareholders to commence proceedings more readily and put directors’ decision-making processes under the spotlight. For example, an activist shareholder such as a hedge fund might allege that a company’s directors had not had proper regard to environmental factors when carrying out their duty to promote the success of the company. The Government response has been that the two-stage procedure for obtaining the court’s permission to continue a claim, particularly the requirement for the shareholder bringing the claim to make out a prima facie case at the first stage, together with the specified factors to be considered by the court, will allow the courts to dismiss “fishing” litigation.

In practice, it remains to be seen how the courts will interpret the new provisions. Even if in the longer term the attitude of the courts prevents an increased number of claims, when the new provisions come into force there may be a short term increase in litigation while shareholders test the courts’ approach.
OTHER MISCELLANEOUS PROVISIONS — DIRECTORS

1. Register of Directors

Directors’ Home Addresses

The Act provides that the register of directors (which all companies are required to keep under section 162) must contain a service address with respect to each director instead of the director’s home address and that such service address may be the company’s registered address (given simply as “The company’s registered office”). This will result in a director’s home address becoming confidential and provide comfort to those directors who do not wish their home addresses to be a matter of public record. However, the Act does require a company to keep a register of the usual residential address of its directors (section 165). Unlike the section 162 register, which remains open to inspection on the same terms as under the old Act, however, there is no requirement for the register of residential addresses to be made available for public inspection. In addition, information relating to directors’ residential addresses is protected from use or disclosure by the company other than in certain prescribed circumstances (section 240). These provisions (unlike the majority of Part 10 of the Act) will only be brought into force in October 2008.

Disclosure

There are a number of minor changes to the disclosures required to be made in the register of directors; for example, particulars of a director’s other directorships will no longer need to be recorded. In addition, the requirement for the register of directors’ interest to be produced at the start of a company’s annual general meeting and for the register to be kept open throughout the meeting has been abolished. The relevant provisions of the Companies Act 1985 were repealed on 6 April 2007.

2. Foreign Disqualification

Part 40 of the Act gives the Secretary of State power to make regulations relating to persons who are subject to foreign restrictions. Foreign restrictions include, among other things, a person being disqualified from acting in connection with the affairs of a company in accordance with the laws of a country outside the UK. The regulations may disqualify such a person from acting as a director of a UK company, acting as a receiver of a UK company’s property or from being concerned in any way with the promotion, formation or management of a UK company. No announcement has been made as to when Part 40 is to be brought into force and draft regulations have not yet been published.

3. Directors’ Indemnities and Defence Funding

The Act relaxes further the restrictions on indemnifying directors against breaches of duty. It allows a company that is a trustee of an occupational pension scheme (or an associated company) to indemnify a director against liabilities incurred as a director of such company (a “qualifying pension scheme indemnity provision”) (section 235).
The Act introduces a new right for a shareholder to be provided with a copy of the directors’ qualifying third party indemnity provisions and qualifying pension scheme indemnity provisions which are available for inspection at the company’s registered office. The court will now also be able to compel companies to allow inspections or give copies (section 238).

These provisions will be brought into force on 1 October 2007.

4. Ratification

The Act codifies the right of a company’s shareholders to ratify a director’s breach of duty through means of the passing of an ordinary resolution (section 239(1)). However, the votes of the director concerned (if he is also a shareholder) and those of any persons connected to him must be disregarded with respect to the ratification resolution (section 239(3)). This new provision will be brought into force on 1 October 2007.

Note that, while the Act prevents directors from voting to ratify acts which they have committed in breach of their duties, it does not contain equivalent provisions preventing directors from voting to authorise in advance the same acts.

5. Fair Dealing

Prohibitions Repealed

The 1985 Act prohibited a company from paying directors any remuneration (whether as a director or otherwise) free from income tax (section 311 of the 1985 Act) and also prohibited directors from dealing in share options of the company or any other body corporate in the company’s group (section 323 and 327 of the 1985 Act).

These prohibitions were repealed with effect from 6 April 2007.

Substantial Property Transactions

The Act introduces two important changes to current law concerning substantial property transactions between a company and its directors with effect from 1 October 2007. First, a company may enter into substantial property transactions with a director without first gaining shareholder approval so long as that transaction is conditional upon shareholder approval. Second, an asset will only be considered “substantial” if its value is more than £5,000, rather than the current threshold of £2,000, as long as the asset’s value also exceeds 10% of the company’s total asset value. Note that an asset will always be considered “substantial” if its value is more than £100,000.

Loans to Directors

The general prohibition on a company granting loans to its directors is abolished by the Act. Directors and their connected persons can be granted loans by the company so long as the
shareholders approve. In cases where loans have been made in breach of the provisions of the Act, there will no longer be any criminal penalties. The company can either treat such loans as voidable or have them affirmed. These provisions will be brought into force on 1 October 2007.

**Connected persons**

Changes to the meaning of “connected person” in relation to a director have been introduced by the Act and will be brought into force on 1 October 2007. This is important because provisions regarding such matters as substantial property transactions and loans to directors will apply not only to directors themselves but also to persons who are deemed by the law to be connected to them. The definition of a “connected person” has been extended to include the following:

- the director’s civil partner;
- the director’s children or step-children;
- persons with whom the director lives as partner in an enduring family relationship (unless that person is the director’s grandparent or grandchild, sister, brother, aunt or uncle, or nephew or niece);
- children or step-children of the director’s unmarried partner if they live with the director and have not attained the age of 18; and
- the director’s parents.

**Directors’ service contracts**

The Act introduces some changes into the law governing directors’ service contracts (including providing for the first time a definition for such contracts). The new rules will be brought into force on 1 October 2007. The Act defines “directors’ service contract” as a contract under which a director of the company undertakes to personally perform services for the company or where the services of a director of the company which he undertakes personally to perform are provided by a services company. A copy of such service contracts must be kept at the company’s registered offices or at a place specified by the Secretary of State under regulations for a period of at least one year from the from the date of termination or expiry of the contract. The Act further introduces a right for members of a company to request a copy of a director’s service contract.

Under the Act, shareholder approval will be required if the term of the service contract is to be in excess of two years. Contravention of this requirement will result in the service contract being deemed to contain a term entitling the company to terminate it at any time by giving reasonable notice.
**Payments for loss of office**

The Act widens what is meant by “payments for loss of office” to cover not only a director’s loss of office as a director, but also his loss of any other office or employment with the company and payments made in connection with his retirement.

The Act requires shareholder approval of termination payments made to a person connected to a director. Payments for loss of office in connection with the transfer of an undertaking or in connection with the transfer of shares in the company will have to be approved by the members.

These provisions take effect on 1 October 2007.

**Contract with sole member who is also a director**

From 1 October 2007, in cases where a sole member company enters into a contract with its sole member who is also a director (or shadow director) of the company, the contract must be recorded in writing. If the contract is not in writing then a written memorandum or the first minutes of the board meeting following the making of such a contract must record the terms of the contract.

The requirement to have contracts with a sole member who is also a director of the company recorded in writing will not apply where the contract concerned is entered into in the ordinary course of business. The thinking behind the requirement to have certain contracts recorded in writing is to ensure that records are kept in those instances where there is a high risk of the line becoming blurred as to when a person is acting in his personal capacity and when he is acting in his capacity as that company’s director.
UNFAIR PREJUDICE, FRAUDULENT TRADING AND OTHER OFFENCES

Protection of Members against Unfair Prejudice

In respect of unfair prejudice, Part 30 of the Act largely restates the Companies Act 1985. Most changes are either (i) minor drafting amendments; or (ii) changes made in consequence of the new requirements for a company’s constitutional documents. For example, the requirement under section 461(3) Companies Act 1985 that a company should not make any alteration in its memorandum or articles without the leave of the court has been replaced by a reference in section 996(2)(d) of the Act simply to “alterations in its articles”. This reflects the fact that, under the Act, a company’s memorandum cannot be amended.

There are two potentially significant new provisions:

(i) A member may only bring a derivative claim in the name of the company (a) under Chapter 1 of Part 11 (Derivative Claims and Proceedings by Members) (see ‘Derivative actions’, above); or (b) in pursuance of an order of the court in unfair prejudice proceedings.

(ii) If the court makes an order under Part 30 of the Act amending a company’s articles, unless those amendments have already been incorporated, a copy of the order must be registered by the company with its articles. Every copy of the articles subsequently issued by the company must be accompanied by a copy of the order.

Part 30 of the Act will come into force on 1 October 2007.

Fraudulent Trading

The Act restates section 458 of the Companies Act 1985, save that the maximum sentence for the offence is increased from seven to ten years’ imprisonment (on conviction on indictment) and from six to twelve months’ imprisonment (on summary conviction).

Part 29 of the Act will come into force on 1 October 2007.

Offences

The provisions of section 721 and sections 730-734 of the Companies Act 1985 have been re-enacted, with three key changes:

(i) The “Officer in default” provisions have been refined so that the definition of an officer now includes any director, manager, secretary, and any person who is to be treated as an officer of the company for the purposes of the provision in question. Where a company is an officer of another company, liability for a breach of company law can be imposed upon the company as an officer only if one of its own officers is in default.

(ii) Criminal liability has been removed from the company in certain circumstances. The principle adopted is that, where the only victims of an offence are the company and its
members, then the company should not be liable for the offence. However, where other persons may be victims, then the company should be potentially liable.

(iii) The definition of documents under the Act has been broadened so that it now states that documents “includes information recorded in any form”. This would seem to include information stored electronically, which was potentially not covered under the Companies Act 1985.
COMPANY INVESTIGATIONS

Part 32 of the Act introduces some amendments to the current regime on company investigations. It gives the Secretary of State the power to take appropriate action in cases where the investigation appears to be taking too long. The Act also deals with situations that are currently not dealt with (for example, the resignation or death of inspectors and the ability to appoint replacement inspectors). It is important to note that these changes introduced by the Act take effect by way of amendments to the existing Companies Act 1985 and will come into force on 1 October 2007. The amended portions of the Companies Act 1985 relating to company investigations will be some of the few provisions of the Companies Act 1985 that will remain in effect after the Act is fully implemented.

The Act confers new powers upon the Secretary of State to give directions to company investigators. The Secretary of State may give a company investigator a direction:

> as to the subject matter of his investigation (whether by reference to a specified transaction, a specified area of a company's activities or a specified period of time); or

> requiring an inspector to take (or not take, as the case may be) a specified step in his investigation.

The Secretary of State may direct an investigator to terminate an investigation. However, in relation to those company investigations that have been initiated by the company itself, by its members or by a court order, such a direction can only be given where matters have come to light during the investigation that a criminal offence has been committed and those matters have been referred to the appropriate prosecuting authorities.

The Act provides that an inspector may resign his position by notice in writing to the Secretary of State. The Act also provides that the Secretary of State may remove an inspector by notice in writing to the inspector. In cases where an inspector dies, resigns or has his appointment revoked, the Secretary of State has the power to appoint alternative investigators.

This briefing paper summarises and comments on certain provisions of the Companies Act 2006.

This briefing paper is not intended to provide legal advice, which should be sought on particular matters. Please refer to your usual contact at Slaughter and May for further information about the Act.

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