Introduction
The new Companies Act 2006 (the “2006 Act”) represents the most significant overhaul of UK company law ever undertaken. Now that implementation of the 2006 Act is well under way, insolvency and restructuring lawyers and practitioners alike are turning their minds to the effect of the new law on their practice. This chapter examines some of the key changes and their practical and commercial implications.

Codification and Expansion of Directors’ Duties
For the first time the general duties owed by directors to their companies are set out in the 2006 Act in statutory form. A director’s primary duty to his company must now be to act in a way in which “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(1) 2006 Act). This primary duty is supplemented by a list of six subsidiary matters which a director must have regard to (amongst other things) in order to fulfil his primary duty. It is outside the scope of this chapter to discuss those matters, commonly referred to as “enlightened shareholder value”, which are well documented elsewhere. However, of particular interest here is the fact that the primary duty is further qualified by section 172(3), which provides that it is “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.”

The duty to act in the interests of a company’s creditors is provided in both statute and in the common law. It is assumed that the reference in section 172(3) to “any enactment” is a reference to statutory concepts such as wrongful and fraudulent trading. If applicable to a given situation, they would qualify a director’s duty to promote the success of the company for the benefit of its members.

Likewise, there are instances in case law in which it has been held that the duty of a director to act in the interests of the company must be substituted by the duty to consider the interests of creditors. The reference in section 172(3) to “any rule of law” is a reference to this developing case law. However, it is not clearly established precisely when the duty to act in the interests of members of the company switches to a duty to act in the interests of its creditors. It is a well known fact that when a company is clearly solvent there is no duty to consider creditors’ interests. By contrast, when a company is insolvent its directors must consider its creditors’ interests, rather than those of shareholders; it is the creditors’ interests which are at stake. The problem is with the period in between. It was held in the case of West Mercia Safetywear Ltd (in liquidation) v Dodd [1988] BCLC 250 that the duty to consider creditors’ interests must also prevail when a company is nearing insololvency. The Explanatory Notes to the 2006 Act echo this principle and state that: “Subsection (3) will leave the law to develop in this area”.

By way of conclusion, the 2006 Act does not seek to clarify the common law position, it merely recognises it. It therefore remains unclear at what point a director’s duty to promote the success of the company for the benefit of its members must be displaced by a duty to act in the interests of creditors, or even if it is possible for the two duties to exist in tandem. There was, and still is, a ‘twilight zone’. However, given the difficulty of creating a test capable of dealing with all possible situations, the decision to leave the common law in its current developing state provides no surprise.
Derivative Claims and Proceedings by Members

The new derivative claims procedure

Until recently, the availability of derivative claims in the UK had been governed by case law, which had long been considered complex and obscure. From 1 October 2007 the 2006 Act has provided a new statutory derivative procedure “with more modern, flexible and accessible criteria for determining whether a shareholder can pursue an action”.

Under the 2006 Act, derivative claims may be brought by a member of a company 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 a company. Possible causes of action include, amongst other things, failure to observe the new statutory fiduciary duties of directors (for which, see commentary on section 172 of the 2006 Act above). As such, the current scope of derivative actions has been increased. In addition, it will not now be necessary, as it was under the common law, for a member to prove that a director has benefited personally from the breach, or that the director who carried out the wrongdoing is in control of the majority of the company’s shares.

The 2006 Act introduces a new two-stage process for members who wish to bring a derivative claim against a company’s directors or another person (or both). Under the first stage, a member must apply to the court for leave to continue once derivative proceedings have been commenced. If the court considers that the application and the evidence filed in support of the derivative claim do not disclose a prima facie case for granting leave, the court must dismiss the member’s application and may make any consequential order (e.g. in relation to costs) which it considers appropriate. If the court determines that there is a prima facie case for granting leave, under the second stage of the process, it may request further information from the company as part of its more detailed assessment of the application before the substantive action begins.

Impact of the changes on corporate reconstructions

During passage of the Companies Bill through Parliament, concern was raised that the new law could have an adverse effect on company reconstructions. Attention was focussed on section 260(4), which provides that a cause of action may arise before as well as after the person seeking to bring a derivative claim has become a member of the company. It was thought that new investors might rely on this section to take up company shares so that they could later challenge alleged wrongs which had taken place prior to commencement of their membership, with the intention of upsetting a restructuring.

In recognition of the risk of vexatious claims being brought by new members, a long list of safeguards was put in place to ensure that, wherever possible, such claims would be prevented from proceeding beyond the first stage of the application process, hence avoiding the involvement of directors and expense for the company. In particular, in considering whether to give permission (or leave) to continue a claim, the court must take into account whether a member is acting in good faith; and must consider the views of members of the company who have no personal interest in the matter. Leave to continue cannot be given if a person acting in accordance with section 172 of the 2006 Act (Duty to promote the success of the company) (for more, see above) would not seek to continue the claim. Where an applicant cannot disclose a suitable prima facie case at the first stage, the court may make various consequential orders against him, including costs and restraint orders. Such measures are intended to strike a balance between deterring members from making vexatious or frivolous claims, and protecting the rights of those with a genuine case.

It is possible that, in the short term, the new procedure will bring with it an increase in litigation, as shareholders test the courts’ willingness to entertain derivative claims. In the case of public companies, derivative actions could be used as a tactical measure for disrupting a restructuring (though it remains to be seen to what extent any such action would have the desired disruptive effect). However, in the case of small private companies with no real market for their shares, it is likely that derivative claims will remain unusual. It is also worth bearing in mind that remedies for derivative claims are made in favour of the company; consequently, members are expected to prefer actions for unfair prejudice, which offer the potential of a buy-out remedy and therefore an exit from membership of the company.
Reversal of the Rule in Leyland DAF

Following the House of Lords ruling in the case of *Leyland Daf (Buchler and another v Talbot and others (Re Leyland Daf Ltd) [2004] UKHL 9*) liquidators were not permitted to meet expenses referable to the costs of winding-up in general out of assets subject to a floating charge. Instead, liquidation expenses had to be taken from the proceeds of assets available for general creditors of the company, or from any surplus monies remaining after realisation of the floating charge.

**Leyland Daf**

In 1993 administrative receivers were appointed by the holder of a floating charge over substantially the whole of Leyland Daf Limited’s undertaking. A portion of the funds that were realised were used to pay preferential debts and to make interim distributions to the floating charge holder. Then, in 1996, the company entered into creditors’ voluntary liquidation. However, it was considered unlikely that sufficient unencumbered assets would be left to meet the expenses of the liquidation. The liquidators (relying on the well established principle in *Re Barleycorn Enterprises Ltd [1970] 2 All ER 155*) obtained a declaration from the High Court that liquidation expenses were payable out of the assets which had been subject to the floating charge. The receivers appealed to the House of Lords, who overruled the decision on the basis that, in this case, property prevailed over priority. The Lords held that there were two separate funds. The first fund comprised the assets subject to the floating charge (insofar as their value covered the secured debt) which belonged to the charge holder. This fund was administered by the administrative receiver. The second fund comprised all other assets (including any surplus from the proceeds of the floating charge) and this fund belonged to the company and was administered by the liquidator. The court concluded that the liquidator could not utilise the assets belonging to the charge holder to meet his expenses.

**Changes to the law under the 2006 Act**

On 6 April 2008, the 2006 Act inserted a new section 176ZA in the Insolvency Act 1986 (the “1986 Act”), which had the effect of reversing the ruling in *Leyland Daf* for liquidations commenced on or after that date. The new section provides that, where insufficient unencumbered assets are available to pay the expenses of a winding-up, the proceeds of assets subject to a floating charge will be available, in priority to the claims of the floating charge holder and to any preferential creditors entitled to be paid in priority to the floating charge holder.

However, the effect of section 176ZA has been reduced somewhat by the introduction of new rules which restrict its application as regards a liquidator’s litigation expenses. It will not be possible for liquidation expenses (above a certain threshold amount) to be paid from the proceeds of assets subject to a floating charge without the approval of the floating charge holder, or a preferential creditor entitled to be paid in priority to a floating charge holder, or the court, as the case might be. Approval will need to be sought as soon as a liquidator identifies that, in order to pay such litigation expenses, he will need to have recourse to the assets subject to a floating charge. Approval must be given by the floating charge holder or the preferential creditor considered most likely to receive only a partial payment as regards their claim to the floating charge assets (the ‘specified creditor’). However, the liquidator can apply to the court for approval instead if the specified creditor will be a defendant in the proceedings to which the litigation expenses relate; or if the specified creditor has declined to authorise the amount of the expenses requested or has authorised a lesser amount which the liquidator considers insufficient; if approval is required urgently; or if the liquidator has not received a response to his request within a specified time.

When the reversal of *Leyland Daf* was proposed, floating charge holders voiced a concern that liquidators would be given a free rein to use floating charge assets to fund speculative recovery actions for the benefit of unsecured creditors. The introduction of the approvals regime for litigation expenses means that such concerns are less likely to be borne out. Nevertheless, it will still be possible for liquidators to meet expenses referable to liquidation in general from floating charge assets without the need for approval. Taken as a whole, the arrangements are intended to strike a balance between protecting the interests of a company’s various stakeholders, at the same time as giving some control to its creditors to limit the quantum of liquidation expenses in certain circumstances.
Reduction of Share Capital

Reduction of capital by private limited companies

Embedded in modern UK company law is the principle that the capital of a company should be maintained. However, public and private limited companies are currently permitted to reduce their capital if the circumstances are such that the company’s creditors would not be prejudiced and provided that the procedure set out in the Companies Act 1985 (the “1985 Act”) is followed, which includes applying to the court for an order confirming the capital reduction. The provisions of the 1985 Act will largely be restated in the 2006 Act, however new simplifying measures will be introduced for private limited companies.

The new provisions are due to come into force on 1 October 2009. The new provisions will allow private limited companies to reduce their share capital without needing to go to court to seek confirmation of the reduction (although the court approved route will remain open to them). Instead, these companies will be able to follow an ‘out-of-court’ procedure by obtaining a special resolution of their shareholders supported by a directors’ solvency statement. In addition, the presence of specific authorisation in the articles of association of a company to reduce its share capital will no longer be required.

Under the new solvency statement procedure, directors will be required to make a statement (in a prescribed form) confirming the solvency of the company not more than 15 days before the date on which the special resolution authorising the reduction in capital is passed. Copies of both the special resolution and solvency statement must then be sent to the Registrar of Companies.

The solvency statement must include confirmation from each director that he has formed the opinion that the company will be able to pay (or otherwise discharge) its debts as they fall due during the year following the date of the statement or, if the company is to be wound up, that it will be able to pay or discharge its debts within 12 months of commencement of the winding up. When forming their opinion the directors are required to take into account all of the company’s liabilities (including any contingent or prospective liabilities). Although there is no requirement for company accounts to be drawn up, it is expected that auditors will be asked to assist in the process.

Impact of the changes on corporate reconstructions

Capital reductions, often seen in the context of schemes of arrangement, may be used as a means of eliminating accumulated losses. For private limited companies wishing to undertake reductions in capital, the new regime will provide a faster and more cost efficient way to do so, as compared with the court order route.

However, it will not be possible to use the new solvency statement procedure if, as a result of the reduction, there would no longer be any member of the company holding shares other than redeemable shares. The key principle is that a company should not be capable of reducing its share capital to zero. Therefore, a company which needs to do this, for example as part of a scheme of arrangement, will have to do so via the court order route. The main reason for this is that the court order route offers an extra necessary safeguard, which is that the court may use its discretion to ensure that when a company reduces its share capital to zero the reduction is momentary and is immediately followed by a recapitalisation.

The 2006 Act also includes a new section which provides that a capital reduction carried out using the court order route, which forms part of a compromise or arrangement sanctioned by the court, will take effect on delivery of both a statement of the company’s capital (as reduced by the resolution) and the court order to the registrar of companies; hence at the same moment as other aspects of the compromise or arrangement.

Changes to the Substantial Property Transaction Regime and its Application to Administrators

The substantial property regime

On 1 October 2007 a new regime regulating substantial property transactions (“SPTs”) between companies and their directors and connected persons came into force, replacing the equivalent provisions of the 1985 Act.

Previously, the 1985 Act prevented a company from entering into arrangements whereby a director or a connected person acquired from or sold to the company a substantial non-cash asset, unless those arrangements were given prior approval by an ordinary resolution of the company’s shareholders in general meeting.
Exceptions to the rule for administrators

Under the 1985 Act there was an exception to the rule, which provided that STPs involving directors and connected persons could be undertaken without shareholder approval when a company was in creditors' voluntary liquidation or compulsory (i.e. court ordered) liquidation, but not in members' voluntary liquidation. In other words, shareholder approval was not required when a company was in insolvent liquidation, as they would be unlikely to receive any distributions in those circumstances.

Under the 2006 Act the exception has also been extended to companies in administration, on the basis that the conflicts of interest which a director faces in SPTs – such as the risk of a director's judgment being distorted, or the risk that the company may acquire assets at an inflated value or dispose of them at an undervalue – do not arise when an administrator contracts on behalf of the company.

The new law is likely to be of assistance to administrators who wish to sell the business or assets of an insolvent company back to its directors, without fear of the shareholders exercising their power of veto by refusing to pass the required ordinary resolution. It is often the case that company directors show more interest in acquiring company assets than other parties, and will pay the best price for them.

Implications for administrative receivers

Recommendations were made that the new exception for administrators should also be extended to administrative receivers. It was also suggested that, where there is reason to believe that a company's assets are insufficient to make a payment to its shareholders, administrative receivers should have the option of applying to court for approval of a transaction, by requesting directions and producing evidence to satisfy the court that the price to be obtained was reasonable in the circumstances. However, despite widespread support for the new exception, it has not been enacted. To some, this may present a missed opportunity to address concerns which had arisen out of the case of Demite Ltd v Protec Health Ltd [1998] BCC 638. In that case, although the court held that a company could invoke the relevant section of the 1985 Act to invalidate a sale entered into prior to liquidation between an administrative receiver and a company connected to one of its directors, Park J appeared to have some sympathy with the suggestion that: “it would be irrational and unfair to debenture holders for shareholders to be given a veto power … over one kind of sale which a receiver may wish to make in order to raise funds to repay the money owed to the debenture holder”, and said that “It is something which the legislature may wish to consider”. It should be remembered, however, that the holders of a qualifying floating charge have the power to apply to the court for directions under the provisions of the 1986 Act and that it will still be possible for SPTs to be arranged via this route.

Changes to the Financial Assistance Rules for Private Companies

Abolition of the whitewash procedure

The 1985 Act prohibited private companies from giving financial assistance for the acquisition of their own shares (or for shares in their private parent company). These provisions are omitted from the 2006 Act so that, from 1 October 2008, private companies will no longer be required to go through the “whitewash” procedure (which involves provision by their directors of a statutory declaration of solvency, an auditor’s report and a special resolution of the company’s shareholders) in order to give financial assistance. For companies in distressed merger and acquisitions situations or undergoing rescue refinancing, this is likely to reduce costs and speed up the timetable.

During consultation the question arose as to whether, if the ban on financial assistance were abolished, adequate protection for company creditors would remain. The ban on financial assistance has long been considered somewhat anomalous in its aim to protect creditors' interests, since the prohibition does not depend on there being any detriment to the provider of the assistance or its creditors. Indeed, an action which constitutes financial assistance is often considered to be beneficial to those parties. The abolition of the prohibition in relation to private companies is intended to offer at least a partial resolution of this anomaly.
Registration of Company Charges

On 1 October 2009 the new provisions of the 2006 Act, which regulates the registration of company charges, will come into force. Following a lengthy consultation process, it was expected that the company charges registration regime would be comprehensively reformed. However, the case for widespread reform is still being considered and the changes that have been made are, on the whole, fairly modest. While the 2006 Act does include a general power to provide secondary legislation, the government has indicated that this power will not be utilised on commencement and that it is most likely to be used to address the imperfections of the current system (for example, by amending the list of charges to which the registration requirements apply) rather than to replace it. Consultation on this area is expected at some time in 2008.

Currently, the 2006 Act effects two main changes to the law on registration of company charges. Firstly, it provides the power to make regulations to facilitate information-sharing arrangements between Companies House and persons responsible for maintaining special registers, thus avoiding the current duplicative registration requirements in relation to property such as land, ships and aircraft. The intention is to use the power first so that floating charges registered in a new Scottish register of floating charges will be treated as if they had been registered with the Registrar of Companies. Draft regulations are expected at some time in 2008.

Secondly, the 2006 Act omits the current section of the 1985 Act which requires companies incorporated outside Great Britain, but with an established place of business in England and Wales, to register charges over property in England and Wales. There is no express requirement in that section that overseas companies must have themselves registered with Companies House in accordance the relevant provisions of the 1985 Act. Therefore, overseas companies have typically taken a cautious approach by registering such charges at Companies House regardless of whether the company itself is registered: otherwise known as a “Slavenburg” registration. Long regarded a defect of the current charges registration system, the 2006 Act provides the power to make regulations requiring overseas companies to register specified charges over property in the UK. Draft regulations have been published and are due to come into force on 1 October 2009. The regulations provide that a charge will only be registrable if: it is one of the types registrable by a company incorporated in England and Wales; it is created by an overseas company which has already registered particulars of a place of business in the UK under the new registration regime (the details of which will also be provided as part of the new regulations); and on the date of creation of the charge, the charged assets are situated in the UK. Failure to register will be an offence and will render the charge invalid.

Conclusion

The 2006 Act does contain provisions of importance to corporate recovery and insolvency lawyers and practitioners. In some cases, the provisions deal with widely trailed amendments to specific issues which have arisen in the past, such as the reversal of the decision in Leyland Daf. In other cases, the provisions do no more than seek to ensure that changes to the company law regime are consistent with existing jurisprudence in the insolvency arena, such as the caveats inserted into the new statutory code of directors’ duties. There are other reforms which do not immediately seem to have any particular implication for restructuring and insolvency lawyers and practitioners, but may in the future make distressed mergers and acquisitions easier to facilitate, such as the changes to the substantial property transaction regime and the abolition of the prohibition of financial assistance for private companies.