FRESHFIELDS BRUCKHAUS DERINGER

BRIEFING

SUMMARY 8 NOVEMBER 2006

Companies Act 2006

The Companies Act 2006 received Royal Assent on 8 November 2006. This briefing covers the key implications for your company.

When will the Act come into force?

Most provisions of the Companies Act 2006 (the Act) are expected to come into force by October 2008, but some parts will be effective sooner.

Some sections, including those connected with the implementation of the EU Transparency and Takeover Directives and company communications, are likely to come into force in January 2007. The government is expected to start a formal consultation on its implementation plans in February 2007.

In a number of areas, the Act gives the government power to make regulations, with further consultations expected on the detail.

For more information on UK implementation of the Transparency Directive, please read our briefing note available at www.freshfields.com. We will be commenting on the Financial Services Authority's latest plans for implementation of the Transparency Directive when it publishes the special Directive edition of its newsletter *List!*, scheduled for November 2006. Part of our website is dedicated to Takeover Directive materials, including briefing notes: www.freshfields.com/takeoverdirective.

What happens to the Companies Act 1985?

The Act replaces most of the Companies Act 1985. A small part of the 1985 Act will remain, relating mainly to company investigations and community interest companies.

How will the new law affect existing companies?

It is not yet clear how the Act will apply to existing companies. The DTI issued a consultation paper in August 2006 presenting various options for transitional provisions, but it has not made specific proposals, and the consultation was limited in scope. The formal consultation on the secondary legislation to make transitional arrangements is expected to start in January 2007 and a final version of the legislation is not expected before April 2007 at the earliest. This makes planning very difficult.

Do we need to take action before October 2008?

Preparing for the Act

The new law is intended to simplify and modernise existing rules rather than make any dramatic shift in the company law regime. But there are numerous changes, and many additional requirements for quoted companies.

As a first step, companies should decide how to implement the new regime for communications, including electronic communications, between the company and its shareholders and holders of debt securities that will be brought into force in January 2007. This regime is discussed below. We do not yet have any information about transitional provisions that may deal with the Act's effect on a company's existing

communications procedures. However, an initial approach might include:

- reviewing practices, procedures and documentation for regular communications, such as accounts and reports, summary financial statements and for general meetings;
- talking to the company's registrars about new procedures in development;
- considering how to inform shareholders about new practices, procedures and documentation;
- reviewing the communications provisions in the articles of association of the company and other relevant group companies; and
- considering whether any resolutions on communications might be necessary at the next AGM.

Some thought should also be given at this stage to the other parts of the Act that will be brought into force by October 2008. To begin with, companies might aim, for example, to:

- raise awareness of the Act in the company or group for those affected by the Act;
- plan the review of all practices, procedures and documentation, for example for AGMs;
- make an initial assessment of what other changes may be necessary to the articles of association of the company and other companies in the group; and
- consider how private companies in the group might wish to take advantage of the deregulation offered by the Act (this is discussed further below).

The 2007 and 2008 AGMs

Companies should consider whether any action to deal with the Act should be taken at an AGM held before autumn 2008, by which time the whole of the Act will probably be in force. In the absence of transitional provisions it is not possible to give definitive advice or produce a comprehensive list of topics that might have to be dealt with, but it may be necessary to consider resolutions on, for example, electronic communications with shareholders and holders of debt securities, directors' authority to allot shares, political donations and altering the company's articles of association. In due course, companies will need to review all documentation on general meetings, including the notice of meeting and proxy form. Companies whose securities are admitted to trading on a regulated market should also consider documentation and procedures to implement the new rules allowing a nominee shareholder to nominate a person who holds a beneficial interest in a share to enjoy 'information rights' regarding that share. This is discussed further below.

Articles of association

Most companies will want to change their articles to take account of the Act. As we do not yet know how existing companies will be affected by the Act, we cannot yet know how important it will be for a company to have amended articles in place by the time the Act is fully implemented. It would be possible to pass a resolution amending the articles at an AGM to take effect at a later date when the relevant parts of the Act come into force.

Key points

The Act introduces wide-ranging changes to company law. Here is a summary of the key ones for you to be aware of at this stage.

Directors and derivative actions

The Act sets out the general duties owed by directors to their company in a statutory code. This includes a duty to have regard to a list of factors set out in the Act in considering how to promote the success of the company for the benefit of its members. The government is proposing to issue guidance on these duties. The government's intention was in the main to codify the existing duties without changing them, although we believe that some changes have been made. How significant these changes will be in practice remains to be seen. In particular, it is unclear to what extent they may change the way directors and companies document their decisions. They will raise new questions for directors who have potentially conflicting interests. It would be sensible for companies to review the articles and make any amendments necessary to ensure they reflect the statutory regime and take account of any permitted flexibility and protections, especially to authorise potential conflicts of interest that might arise where the company's directors are also directors of another company.

The general rule remains that only the company can obtain damages from the directors for breach of their

duties. The existing common law right that shareholders have to sue the directors in the company's name if it fails to take action (the derivative action) has been replaced by a procedure set out in the Act. Shareholders will require the court's consent to sue – and must overcome a number of hurdles before this consent can be obtained.

The Act also introduces a statutory procedure allowing shareholders to ratify conduct that breaches a director's duties. This is stricter than the common law because votes in favour of such a decision by a director who is also a shareholder of the company or persons connected to him must be disregarded. These requirements are in addition to any other limitations or restrictions on ratification imposed by the existing law.

It is advisable to review directors' and officers' liability insurance policies against the background of the new duties regime and statutory derivative action procedure.

The Act restates without substantial amendment the law allowing companies to indemnify their directors in certain circumstances. A substantive change has been made to allow a company that is a trustee of an occupational pension scheme, or an associated company, to indemnify a director against liability incurred in connection with the company's activities as trustee of the scheme.

The Act also amends the statutory rules (formerly in part 10 Companies Act 1985) that are intended to promote fair dealing by directors with the company. These include rules on declarations of interest, substantial property transactions, service contracts, loss of office and loans and related transactions. The restated rules are similar to the current regime but with more scope for shareholders' approval and some changes to the exemptions.

There are new rules giving a director the option either to provide his residential address for the public record or to supply a service address and his residential address, with only the service address being available for public inspection. But residential addresses already on the register will not be removed, so this procedure will be of less value to existing directors.

We will be publishing a separate briefing on changes to directors' duties and the new derivative action procedure in due course.

Expanded business review

The Act expands the content requirements for the business review in the annual directors' report. The government has not yet stated the financial year in which these requirements will first apply.

The business review of a quoted company must include, to the extent necessary for an understanding of the development, performance or position of the company's business:

- the main trends and factors likely to affect the future development, performance and position of the company's business;
- information about environmental matters, the company's employees, and social and community issues, including information about the company's policies on these issues and their effectiveness; and
- information about persons with whom the company has contractual or other arrangements essential to the company's business, unless disclosure would in the directors' opinion seriously prejudice that person and be contrary to the public interest. The government has stated that companies will not be required to list their suppliers and customers, or to provide detail about contracts, but they will have to report significant relationships likely to influence, directly or indirectly, the business's performance and value.

Companies are exempted from disclosing information about impending developments or matters in the course of negotiation where disclosure would in the directors' opinion be seriously prejudicial to the company's interests.

Liability for reports

The Act introduces a new safe harbour that will restrict directors' civil liability for the content of directors' reports and directors' remuneration reports, and summaries of those reports. Broadly:

- a director is liable to the company for any loss it suffers as a result of:
  - any untrue or misleading statement in a report, where the director knew or was reckless as to whether the statement was untrue or misleading or
  - any omission from a report of anything required to be included in it which the director knew to be a dishonest concealment of a material fact; and

- a director is not liable to any other person (eg a shareholder or a potential investor in the company) regarding the contents of those reports or summaries. This does not affect any potential criminal liability relating to the reports or any civil penalty.

The safe harbour does not apply to statements made in related documents, such as a chairman's letter sent to shareholders with the report and AGM notice.

The Act also sets up a liability regime to protect companies against possible extended liability for Transparency Directive periodic financial reporting requirements. Our briefing note on the Directive (available at www.freshfields.com) has more information about these requirements. There has been a concern that the Directive may increase the liability of a listed company and its directors and auditors for the accuracy of financial reports. It is arguable that liability might extend beyond existing shareholders to all potential investors, and might also arise under the laws of each of the 25 member states. To help protect companies against this possible extended liability, at least in the UK, the new regime provides that a listed company will be liable to compensate an investor who has acquired securities and suffered loss as a result of an untrue or misleading statement in, or omission from, an annual, half-year or interim management report or a preliminary statement of annual results. But to establish liability a director must have known or been reckless as to whether the statement was wrong or misleading, or have known that any omission was a dishonest concealment. Only the company will be liable to the investor, although the director concerned may be liable to the company.

The government consulted on whether this new liability regime should be extended to cover other disclosures required by the rules of the Financial Services Authority, but decided that it could not consider such a complex issue in time to make relevant changes to the Act and that there should be a formal review. It has a statutory power to make changes to the liability regime if the review concludes that this is appropriate.

Enfranchising indirect investors

One of the government's key aims has been to make it easier for indirect investors to exercise their voting rights. The Act gives members of private and public companies the right to appoint more than one proxy for a meeting (most companies' articles of association already allow this). The Act also allows proxies to vote and speak at meetings notwithstanding anything in the company's articles.

The registered member may also nominate someone to enjoy or exercise all or any of his membership rights if the articles allow.

The Act also creates a new regime allowing a nominee shareholder in a traded company, ie a company whose securities are admitted to trading on a regulated market, to nominate a person who holds a beneficial interest in a share to enjoy 'information rights' regarding that share. These are, broadly, rights to receive all communications that the company sends to its members in general, including notices of meetings and reports and accounts. The default method of communication is by website publication, but the person with information rights may ask through the nominee shareholder to receive hard copies. Companies with such nominated persons will need to send them a statement of possible voting rights when they send them a copy of a notice of meeting. There are also related changes to the notice of meeting to reflect the rights of nominated persons.

Communications with shareholders

There will be a new regime for the communication between companies and shareholders and holders of debt securities of information and documents required or authorised to be sent or supplied under the Act. Website publication of information and documents such as accounts and general meeting notices will become the default position; the Act places a positive obligation on shareholders to request hard copy documents. There is a detailed series of procedures that the company will have to follow, which companies will want to discuss with their registrars. Companies must have a provision in their articles, or approval at a general meeting, to use electronic communications. It is not yet clear how existing provisions in articles dealing with electronic communications will fit with these new provisions.

AGMs

The Act contains a number of new requirements that will affect AGMs – in particular those of quoted companies designed to promote accessibility of information for

shareholders and the public in general. There will be many changes to existing procedures, documentation and website content. A 'quoted' company is, broadly, a company whose shares are officially listed in an EEA state, or admitted to dealing on the New York Stock Exchange or Nasdaq.

The notice period for an EGM will be 14 clear days, even where a special resolution is proposed. Notice for an AGM will continue to be 21 clear days. It is unclear whether the Combined Code requirement of 20 business days for AGMs will be amended to reflect this statutory position.

The Act does not require all-poll voting on resolutions, but allows shareholders in quoted companies to require independent scrutiny of a poll (for example, by the company's auditor – but not the registrar) in certain circumstances. To trigger the independent scrutiny requirements, requests must be made by:

- members representing not less than 5 per cent of the total voting rights of all members who have a right to vote on the matter to which the poll relates; or
- not less than 100 members with the right to vote on the matter to which the poll relates and who hold shares in the company on which there has been paid up an average sum per member of not less than £100.

The requests may be made up to one week after the meeting. The Act does not set out the scrutiny procedure, nor the consequences of an adverse scrutineers' report. The Act also provides for compulsory website publication of poll results at general meetings.

New rules permit shareholders of quoted companies to require the company to publish on a website a statement setting out any matter relating to the audit of the company's accounts to be laid before the next AGM, or any circumstances connected with a departing auditor of the company since the previous AGM, that the members propose to raise at the next AGM. The same minimum shareholder requirements apply as for poll scrutiny requests. Companies are required to give certain information about these rules in the AGM notice.

Public companies, not only those that are traded, must in certain circumstances pay for the cost of circulating AGM resolutions requisitioned by shareholders, where the shareholders' request is received before the company's financial year-end.

Auditors' liability and independence

Companies can agree a limit on the auditors' liability arising from an audit for the financial year specified in the agreement. The agreement cannot apply to more than one year's audit. Shareholders must authorise the principal terms of the agreement, and can also cancel it. Shareholders in private companies can pass a resolution waiving the need for approval. The agreement is not effective to limit liability to an amount that is less than is 'fair and reasonable'. The Act gives the government power to make regulations laying down rules for disclosure of an agreement – probably as a note to the accounts or in the directors' report.

The Act also contains provisions aimed at increasing auditors' independence, including the naming of the individual lead auditor, as well as the audit firm, in audit reports (although provision is made for confidentiality in exceptional cases).

Share capital and capital maintenance

The Act makes various alterations to share capital rules and there may well be further changes over the next few years as a result of EU legislation. Broadly, the Act does not prohibit private companies from giving financial assistance for the acquisition of their own shares, so they will not need to use the 'whitewash' procedure, but it is possible that common law rules will still make financial assistance difficult in some circumstances. There is a new procedure by which a private company can reduce its capital without court approval on the basis of a directors' declaration of solvency (the existing court approval procedure will still be available as an alternative).

The Act also abolishes the requirement to have authorised share capital for private and public companies, but shares must still have a nominal value. Companies formed under the Act are not required to restrict the total number of the shares they can allot, but they may do so if they wish. The government has not yet announced what the transitional provisions will say about the effect of an existing company's authorised share capital. These might provide that authorised share capital ceases to have any effect. If companies wish to retain a restriction on the number of shares the company can allot, it will be necessary to incorporate a restriction in the articles.

Directors of private companies will not require any authority to allot shares where the company has one class of shares, unless the articles provide otherwise.

Public companies are still required to have an allotted share capital of not less than the 'authorised minimum' (currently £50,000), but the Act allows this to be satisfied either by reference to sterling or by euros, but not partly in sterling and partly in euros. The government has power to prescribe the amounts of sterling and euros to be treated as equivalent for this purpose.

The Act sets out a new procedure for redenominating share capital from one currency into another, which has caused uncertainty in the past. It permits redenomination by ordinary resolution, establishes the rate at which redenomination is to be effected and sets out steps for calculating the new nominal value of each share.

Shareholders' register

The Act changes the rules on inspection and copying of a company's register of members. A person wishing to inspect or obtain a copy of the register must give his name and address and the purpose for which the information will be used, and equivalent information on any person to whom the information will be disclosed. It is an offence knowingly or recklessly to make a statement in a request that is materially misleading, false or deceptive. It is also an offence to disclose information to another person, or to fail to do anything with the result that the information is disclosed to another person, knowing or having reason to suspect that that person may use the information for a purpose that is not a 'proper purpose'. There is no definition of 'proper purpose' in the Act. The company has five working days either to comply with the request or to apply to court on the basis that the request has not been made for a proper purpose.

The government will consult on proposals that public companies be exempt from the obligation to put a shareholder's address on the public record at Companies House if he holds less than 5 per cent of any class of shares, and that private companies should have no obligation to disclose an address whatever the amount of the shareholder's holding.

Institutional investors – disclosure of voting

The Act gives the government power to require institutional investors to disclose how they have voted certain types of shares they own or in which they have an interest. The government has stated that it will only use this power if a voluntary regime fails to improve disclosure and after full consultation. If mandatory disclosure goes ahead, the obligation will be enforceable in civil proceedings by any person to whom the information should have been provided (to be set out in the regulations) or to a specified regulatory authority. This has met strong opposition from institutional investors' representative groups who have claimed that the proposed mandatory system would be unworkable in practice and point to increasing voluntary disclosure, often on websites.

Electronic transfer and holding of securities

The government's existing powers to make regulations about the electronic transfer and holding of securities can only be used to permit paper-free systems. The Act extends this power so that electronic systems can be made mandatory for all or any class of companies and for all or a particular type of a company's securities. The government has said that a decision on the case for a mandatory approach will not be made without wider consultation, but it has kept its options open in the Act.

Simplified regime for private companies

One of the government's main aims in drafting the Act was to deregulate private company administration pursuing its 'think small first' policy. Various deregulatory measures are included in the Act. For example:

- a company secretary will no longer be compulsory;
- AGMs will be optional; and
- written resolutions will require a simple majority or 75 per cent of eligible votes, rather than unanimity as at present. It will no longer be possible for companies to use non-statutory written resolution procedures contained in their articles.

Conclusion

The Act, with the seventy or so sets of regulations to be made under its powers, will affect most aspects of the UK's company law regime. The Act is in many ways

This material is for general information only and is not intended to provide legal advice.

© Freshfields Bruckhaus Deringer 2006
www.freshfields.com

deregulatory for private companies, but quoted companies will be subject to increased regulation, especially regarding AGMs and annual reports.

Although the Act will not be fully implemented for some time, and we have little information about transitional provisions, some forward planning will be essential. Please contact us if you would like to discuss specific points in more detail.

For further information please contact

Vanessa Knapp
T +44 20 7832 7030
E vanessa.knapp@freshfields.com

Martin Nelson-Jones
T +44 20 7832 7307
E martin.nelson-jones@freshfields.com

Stephen Hewes
T +44 20 7832 7323
E stephen.hewes@freshfields.com

16878