

The Practical Implications of the Companies Act 2006

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Companies Act 2006 (the “Act”)

Introduction

Having received the Royal Assent in November 2006 the Act is the longest ever to pass through Parliament. The Act runs to 1300 sections. The index runs to 58 pages.

The Act has come into force in stages. The earliest provisions of the Act came into force on 1 April 2007. The Act will not come fully into force until 1 October 2009.

The Act seeks to simplify and modernise Company Law. The Act particularly aims to free owner managed businesses from the technicalities of Company Law which are not relevant to them.

The far reaching changes introduced by the Act should allow companies to save costs and thereby increase the efficiency of the economy.

Changes to a Company's Constitution and New Model Articles

Memorandum is to become a Simpler Document

At present the memorandum of association is a fairly lengthy document, setting out the subscribers, the authorised share capital of the company and, typically, a list of objects. From 1 October 2009, the memorandum will be a much simpler document, with the sole purpose of evidencing the intention to form a company (section 8 of the Act).

The memorandum will no longer contain the objects or a clause recording the authorised share capital of the company. This is because a company will no longer be required to have an authorised share capital.

The information set out in an existing company's memorandum, will from 1 October 2009, be regarded as being imported into the Company's articles of association. The authorised share capital will continue to act as a restriction in an existing company's articles unless their articles of association are amended. Existing companies may want to take advantage of this simplification by passing a resolution to remove the objects clauses from their articles of association.

Entrenched Articles

In addition, a company will be able to provide that certain of its articles should be entrenched. The articles may therefore provide that certain of their articles cannot be amended without certain requirements being met or procedures complied with that are more restrictive than the procedure for a special resolution (section 22 of the Act). Entrenched articles can only be inserted into the company's articles of association if they are inserted on incorporation or with the consent of all the members of the company.

New Model Articles

From 1 October 2009, Table A will no longer be the Default Model Articles for New Companies.

Instead, there will be three sets of new model articles. These will be:

- Model Articles for Private Limited Companies
- Model Articles for Public Limited Companies
- Model Articles for Companies Limited by Guarantee

The new model articles for private limited companies are expressed in simpler language than Table A and do not repeat provisions that are already provided for in the Act. They are therefore a much shorter document and omit provisions dealing with liens over shares and forfeiture of shares. However, the model articles for private limited companies are basic and aimed at owner managed companies rather than private companies with a more complicated share or ownership structure.

A few interesting aspects of the new model articles for private limited companies are as follows:

- Regulation 15 provides that directors must ensure a company keeps records of the decisions of the directors for at least 10 years. This reflects a new provision in the Act (section 248). The 1985 Act was silent on this point. The Act provides that accounting records should be kept for 3 years in the case of a private company.
- The new model articles do not provide for directors to retire by rotation. It is rare that directors do actually retire by rotation these days. This is a reflection of the new model articles reflecting current practice.
- The new model articles only provide for fully paid shares to be issued and do not provide for partly paid shares. It is unusual to see partly paid shares now, but there are some circumstances in which they are used, for example, in employee share schemes.
- The new model articles do not make provision for an AGM. This assumes that the company wishes to take advantage of the provisions of the Act, which permits private limited companies to no longer hold an AGM. This was brought into force on 1 October 2007. However, some larger private companies will wish to continue to hold AGM's as a way of keeping their shareholders informed. If this is a case, an amendment to the model articles would be required.
- The new model articles do not require a company secretary to be appointed. Again this reflects that from 6 April 2008, private limited companies no longer have to appoint a company secretary. However, many private companies will still want a company secretary to be appointed to deal with general company administration.

Recommended Changes To Existing Articles Of Association

Articles which override the Act

Companies should consider reviewing and amending their articles in light of the changes set out below, as any provision in a company's articles in relation to these matters will override the Act. Therefore, to take advantage of these changes, existing articles should be amended.

AGM's

Since 1 October 2007, private companies are no longer required to hold an AGM unless the articles of a company require it. Companies wishing to take advantage of this provision should not only remove the requirement to hold one from their articles but also delete any reference to an AGM in its articles in order to avoid such a provision being interpreted as requiring one to be held. It should be noted that Table A does require a company to hold an AGM every 15 months.

Notice of Meeting

Since 1 October 2007, all shareholder meetings can now be called at 14 days notice, (except for AGMs held by public companies which continue to require 21 days notice). This is subject to any provision in a company's articles requiring a longer period of notice, which will override the provisions of the Act. Existing articles will usually include regulation 38 of Table A which provides that an AGM or EGM called for the passing of a special resolution requires 21 clear days notice.

Short Notice

Since 1 October 2007, the Act also reduces the percentage of votes required to be cast to authorise calling a general meeting at short notice from 95% to 90% – subject to any provision in the Articles stipulating a higher percentage (Table A sets out that 95% is required).

Company Secretary

From 6 April 2008, the Act no longer requires private companies to appoint a company secretary although they can appoint one if they wish. If companies have specific provisions in their articles which expressly require the company to have a company secretary (Table A states one must be appointed), they will need to change their articles before taking advantage of the change.

E-communications

Whilst the 1985 Act provided for electronic communication with shareholders in certain circumstances, the Act allows companies to use e-communication for all types of communication. The right for shareholders to receive materials in paper format remains, although it is an attractive proposition for companies with a large shareholder base to be able to send out company documents without incurring large printing costs. It is possible to make website communication the default form of communication under the Act by inserting a provision in the articles. It is also possible to insert a provision allowing communication via e-mail, however the express consent of shareholders is required.

Act overrides Articles

All of the provisions in respect of proxies, corporate representatives, written resolutions and registration of transfers **override** any statement in a company's articles to the contrary. Therefore any articles in conflict with the new provisions should be removed or amended to reflect the true position and to prevent the articles presenting a misleading picture.

Proxies

The Act has enhanced the rights of proxies and those appointed to represent corporations at shareholders meetings. Non-working days are no longer included in the minimum time allowed for depositing a form appointing a proxy prior to a meeting. In addition, proxies now have a statutory right to speak at general meetings and vote on a show of hands.

Corporate Representatives

A corporate shareholder may now appoint multiple corporate representatives. This avoids difficulties in the event of a normal representative being unable to attend and also allows for a number of corporate representatives to, although only one may exercise voting powers at the meeting.

Written Resolutions

Since 1 October 2007, written resolutions of shareholders can now be passed by a simple majority (Ordinary Resolutions) or holders of 75% of voting rights (Special Resolutions) rather than by unanimous consent as previously required.

Registration of Transfers

From 6 April 2008, there are new provisions in the Act in relation to the registration of transfers. Often articles state that directors can suspend registration of transfers for up to 30 days in any one year. Under the Act transfers must be registered, or reasons given for a refusal to register the transfer, as soon as practicable and at the latest within two months of the transfer being lodged. Therefore any power to suspend registration of transfers is void.

Provisions Effective From 1 October 2009

Memorandum of Association

From 1 October 2009, a company's constitutional documents are set to change considerably. The objects clause contained in the memorandum of association of existing companies will become part of the articles of the company. No filing needs to be done at Companies House to reflect this change, which takes place by operation of law. However, this means that a company can now elect to remove any restrictions on its powers and if it wishes to have unlimited powers it may remove the objects clause by amending its articles.

Authorised Share Capital and Director Authority to Allot Shares

Companies are no longer required to have an authorised share capital, and can remove all reference to the share capital in the constitutional documents so that there will be no ceiling on the amount of shares a company can issue. In addition to this, directors of private companies with only one class of share (before and after any allotment) will no longer be required to obtain authority from shareholders to allot shares. Both of these provisions are

subject to the articles stating a limit on share capital and on the director's authority to allot shares.

Therefore companies must consider whether they wish to take advantage of these deregulatory provisions by making amendments to their articles. Even if a company does not wish to take advantage of these provisions, it is worth considering updating articles of association to reflect the new position of the objects clause and authorised share capital in order to reflect the new status of the certain sections of the constitutional documents of a company.

Changing the Company Name

Currently a change of company name requires shareholders to pass a special resolution. The Act allows articles to contain a provision giving the directors power to pass a resolution to change the company name.

When to Amend?

Unless a company wishes to take advantage of any of the changes which have already been implemented, it is recommended that companies undertake a review of and amend their articles once all new provisions are in force, on 1 October 2009.

Annual Returns

Companies are no longer required to provide the names and addresses of all shareholders in any annual return made up after 1 October 2008. Instead, a company must state whether or not it was a 'traded company' during the return period. The shareholder information which must be provided depends on whether it was a traded company. It is worth noting that for the purposes of the Act that companies listed on the Alternative Investment Market (AIM) are not 'traded companies'.

Private companies must provide the following information in their annual return:

- Names of every member, *not* including addresses;
- The number of shares of each class held by all members at the date the return is made up to;
- The number of shares of each class transferred during the return period by each such member, or former member, and the dates of such transfers;
- If the names of the members are not in alphabetical order, a list must be annexed to the annual return which enables entries related to any given person to be easily found.

If the annual returns for the previous two years (previously three years) have listed the above particulars, a company is then required only to provide information in respect of persons ceasing to be members during the period and shares transferred.

If a company has converted any of its share capital into stock, it must provide information in respect of the amount of stock created in place of shares.

Traded companies must provide the following information in an annual return:

- The names and addresses of all members holding at least 5% of the issued shares of any class in the company at any time during the return period, and the number and class of such shares. Information regarding those holding less than 5% does not need to be provided;
- The number of shares of each class transferred during each period, by or to members holding at least 5% of the issued shares of any class at any time during the return period, and the dates of the registration of those transfers;
- If the names of the members are not in alphabetical order, a list must be annexed to the annual return which enables entries related to any given person to be easily found.

New Penalty Regime For Filing Accounts

The new penalty regime introduced by the Act in respect of filing a Company's annual accounts came into force on 1 February 2009.

Penalties for late filing have risen and there is now a faster rate of increase in penalties for companies who file their accounts more than one month late. In addition, any company filing its annual accounts late for a second year running will have their fine doubled. A table of the new penalties is set out below:

<u>ACCOUNTS DELIVERED</u>	<u>PRIVATE COMPANIES</u>	<u>PUBLIC COMPANIES</u>
Less than 1 month late	£150	£750
1 month – 3 months late	£375	£1,500
3 months – 6 months late	£750	£3,000
More than 6 months late	£1,500	£7,500

The new regime will apply to all accounts from 1 February 2009, regardless of when they are due to be filed. Companies House will continue to send reminders to companies prior to the deadline for filing.

In addition to the above penalties, directors of companies are also personally liable for failure to file accounts and can be fined up to £5,000, and for continued contravention, £500 per day. It is also likely that by failing to file accounts a director will be acting in breach of his or her duty to promote the success of the company or to exercise reasonable care, diligence and skill.

There are other important points to note in respect of a company failing to file its accounts on time. Such action may trigger defaults under financing or credit agreements and enable lenders to withdraw funding. Creditors and credit insurance underwriters treat failure to file accounts as a warning as to the financial position of a company. Furthermore, Companies House is becoming more vigilant in penalising companies for filing their accounts late, therefore directors should be alert to the need to prepare and file accounts on time.

It is also worth noting that when a company amends its articles of association, a copy of the amended articles must be sent to Companies House within 15 days – failure to do so is a criminal offence. A civil penalty of £200 may also be charged to a company failing to file amended articles within the time limit.

Directors Duties

Directors have the power to take the majority of business decisions on behalf of companies and therefore various duties are imposed on them to ensure the company's interests are protected.

Until now, the majority of directors duties, including the duty to act in good faith; the duty to act in the best interests of the company; the duty to avoid conflicts of interest; the duty not to profit from office and the duty of care and skill were all enshrined in the common law.

Prior to the implementation of the Act the government decided that the common law on directors' duties lacked certainty and was not easily accessible. The Act therefore sought to codify the directors' duties into a statutory statement of seven general duties, which came into force at different times, but are all now in force.

The seven duties are as follows:

- S.171 – the duty to act within a director's powers;
- S.172 – the duty to promote the success of the company;
- S.173 – the duty to exercise independent judgement;
- S.174 – the duty to exercise reasonable care, skill and diligence;
- S.175 – the duty to avoid conflicts of interest;
- S. 176 – the duty not to accept benefits from third parties;
- S. 177 – the duty to declare an interest in a proposed transaction or arrangement.

Section 171 – Duty to act Within a Director's Powers

Section 171 provides that a director must:

- act in accordance with a company's constitution; and
- only exercise powers for the purposes for which they are conferred

This is a codification of the existing common law that directors must use their powers for a proper purpose. From 1 October 2009, the constitutional powers will be exclusively found in the Articles of Association of the Company and the director should be satisfied that he has the power to properly conduct the affairs of the Company. If the director is not satisfied he has the power to act in a certain way, he should seek to have his actions ratified by the members of the company.

Section 172 – Duty to Promote the Success of the Company

There has been a lot of commentary on this section. Whilst, the government has insisted that the Act merely codifies the existing common law, most commentators believe that this section imposes new duties on directors, which are based on the fiduciary duties of good faith.

Section 172 provides that:

“A director must act in a way he considers, in good faith, would be most likely to promote the success of the company for the benefit of the members as a whole and in doing so have regard (amongst other matters) to -

- a) the likely consequences of any decision in the long term;
- b) the interests of the company's employees;
- c) the need to further the company's business relationships with suppliers, customers and others;
- d) the impact of the company's operations on the community and the environment;
- e) the desirability of the company maintaining a reputation for high standards of business conduct; and
- f) the need to act fairly as between the members of the company.

Whilst the duty to have regard to the interests of the employees of the company as well as the interests of its members was provided for in the 1985 Act, this section has been seen to introduce wider corporate social responsibility into a director's decision making process than has been seen before. The detail contained in the section enables directors to have guidance as to the areas that they should have regard and encourages a director to look at the long term success of the company, not just short term profits.

It remains to be seen in practice how a director is expected to balance all of these factors, especially when some may conflict with others. Given the uncertainty surrounding this section, it is important that detailed board minutes are kept of directors' decisions recording the reasons for the decisions.

In practice, we have generally seen greater explanation in minutes of how a particular resolution promotes the success of the company for the benefit of the members as a whole.

Despite all the commentary, there has been a case called *West Costal Capital (Lios) Limited [2008]*, in which the Judge comments that the section "appears to do little more than set out [in] the pre-existing law on the subject". It remains to be seen how practice and case law will develop.

Section 174 – Duty to Exercise Reasonable Care, Skill and Diligence

The duty set out in section 174 codifies the common law duty of care and skill. Section 174(2) provides the degree of "care, skill and diligence" expected from a director, which is:

- the care, skill and diligence that would be exercised by a reasonably diligent person with –
 - 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; and
 - the general knowledge, skill and experience that that director has.

This means that there is a minimum standard of care and skill that a director must have regardless of his abilities. Non-executive directors who do not have a day to day role in the company, need to be careful that they are actually meeting the first objective standard. A non-executive director has the duty to keep himself informed about the business activities and financial status of the company, to attend board meetings with fair regularity and to check on the activities of the full time directors.

Today, it is recognised that the office of a non-executive director involves potentially onerous responsibilities particularly with regard to corporate governance issues. There has been a

great deal more focus on the duties of non-executive directors and the Combined Code of Corporate Governance specifically sets out guidance for non-executive directors (although the code is not legally binding).

This confirms a general trend that started with the relatively low standard of care established in the case of *Re City Equitable Fire Insurance Co* (1925), which stated, “*Directors have to be watchdogs not bloodhounds*”. Case law since that date has gradually recognised an increasing responsibility on non-executive directors.

The original common law duty of care, skill and diligence was an area of law where the case law has developed and the standard has become higher over time. It’s therefore useful for directors that the duties have been codified in the 2006 Act.

Conflicts of Interest

The new provisions regarding conflicts of interest came into force on 1 October 2008.

The Act distinguishes between two types of conflicts of interest:

- Transactional Conflicts (sections 177 and 182)
- Situational Conflicts (section 175)

Transactional Conflicts

Transactional conflicts are those that directors may have in relation to transactions or arrangements with a company. For example, where a director is a shareholder in a target company, a takeover of the target would constitute a transactional conflict.

Sections 177 and 182 largely restate the provisions of section 317 Companies Act 1984.

Sections 177 and 182 require that a director declare the nature and extent of a direct or indirect interest in a proposed or existing transaction or arrangement.

The key differences between the 1985 Act formulation and the Act are that a director must declare the extent as well as the nature of the interest. Furthermore, whilst proposed and existing contracts were dealt with together under Section 317 Companies Act 1985, the Act 2006 deals with proposed transactions and arrangements under Section 177 and existing transactions under Section 182. There are also different sanctions for breaches of Section 177 to Section 182.

Situational Conflicts

In addition to the statutory duties imposed on directors by Section 177 (Duty to declare interests in proposed transactions or arrangements) and Section 182 (Declaration of interest in existing transactions or arrangements) of the Act, Section 175 introduces a new statutory duty to avoid situational conflicts of interest.

Situational conflicts are those that arise by virtue of a director's position where no transaction or arrangement is involved.

Section 175 places a director of a company under an obligation to:

“s175(1) avoid situations in which he [or she] has, or can have, direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company.”

Under Section 175(7) any reference to a conflict of interest includes a conflict of duties. The definition of 'conflict of interest' is wide and includes conflicts of interest that are actual or potential and are direct or indirect.

Possible conflicts of interest include:

1. Directors with a significant shareholding in their own company;
2. Investor directors appointed by private equity investors;
3. Executive directors with non-executive directorships in other companies;

Section 175 represents a change of emphasis from the previous common law, imposing on

directors a positive duty to avoid conflicts rather than disabling directors from acting in such situations. The duty will not be breached in two situations. The first is a situation which “cannot reasonably be regarded as likely to give rise to a conflict of interest”. The second is where the situation has been authorised by the board. The existing practice of a director absenting himself from deliberations in which he has a conflict will **not** be sufficient and board or shareholder authorisation will be required.

Authorisation

The Companies Act 2006 contains a new procedure whereby directors can authorise conflicts by a majority vote, but only those directors who are not themselves interested in the matter can vote and be counted in the necessary quorum for the meeting.

In the case of a public company it is necessary to amend the company’s articles of association in order to adopt this procedure.

In the case of a private company incorporated before 1st October 2008, it will be necessary for the shareholders to pass an ordinary resolution approving the authorisation provisions of Section 175. The resolution should irrevocably authorise the directors to authorise each other’s conflicts of interest under Section 175.

For private companies incorporated after 1st October 2008 the authorisation provisions of Section 175 will apply by default so long as the company’s constitutional documents (the combined memorandum and articles of association) do not prohibit this.

We envisage that most of our corporate clients will wish to grant authority to their directors to authorise conflicts of interest to avoid breaching Section 175.

The abolition of the prohibition of financial assistance by private companies

From **1 October 2008**, the prohibition of financial assistance by a **private company** for the purchase of shares in itself or its holding company has been abolished.

The prohibition of financial assistance by a **public company** (or by its private company subsidiary) for the purchase of shares in the public company remains.

Now the restriction has been lifted for private companies, it is likely that transactions will become simpler. There is now no need for directors to obtain reports from the company's auditors and swear statutory declarations of solvency in order to "whitewash" transactions. Directors will no longer have to worry about the possibility of committing a criminal offence if a private company gives financial assistance. There is initial evidence that the lifting of the prohibition may already be having an influence on the structure of acquisitions.

The whitewash procedure existed primarily to protect the interests of both creditors and minority shareholders. The interests of both groups will still need to be safeguarded under the new regime.

Whilst the "whitewash" procedure previously required might have been seen as unduly onerous in some circumstances, it did provide a checklist for directors to follow to ensure that any security granted to a bank would be valid and enforceable. Under the new regime banks need to be certain that the giving of security is within the company's capacity, is given for the company's benefit and that the company is solvent after the giving of security. It is also necessary to ensure it does not constitute an unlawful reduction of capital.

Therefore, when giving financial assistance private company directors will still need to give consideration to:

- (i) the company's capacity to give financial assistance;
- (ii) their directors duties and whether the transaction is for the company's benefit;
- (iii) the solvency of the company; and
- (iv) capital maintenance.

Capacity

Where the financial assistance involves an "upstream" guarantee the company should have an express object permitting upstream guarantees. Many banks also insist that before security that will constitute financial assistance is entered into an express provision permitting the giving of financial assistance is included in the company's constitution. It is also worth bearing in mind that companies incorporated between 1 July 1948 and 2 December 1981 with unamended Table A articles will have an article prohibiting the giving of financial assistance and this article must be deleted or disapplied.

Corporate Benefit

Section 172 of the Companies Act 2006 provides that a director "must act in a 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". In doing so regard (amongst other matters) must be given

to:-

- (a) the likely consequences of any decision in the long term;
- (b) the interests of the company's employees;
- (c) the need to foster the company's business relationships with suppliers, customers and others;
- (d) the impact of the company's operations on the community and the environment;
- (e) the desirability of the company maintaining a reputation for high standards of business conduct; and
- (f) the need to act fairly as between members of the company.

Case law provides that when considering whether to enter into a transaction, (eg giving security) the directors must act in a way they believe to be in the best interests of the company and for the benefit of the company and not just in the best interests of and for the benefit of the group as a whole (*Rolled Steel Products (Holdings) Ltd v British Steel Corporation*).

If corporate benefit cannot be clearly established then the directors will be in breach of their duties and the company may not have validly entered into the transaction. **If the recipient of the security is on actual or constructive notice of this breach, the security itself will be unenforceable.**

It is established practice for the directors to record in the board minutes the reasons why they believe granting the security or the giving of other financial assistance is in the best interests of the company and for the benefit of the company.

In addition, if there is any doubt as to whether granting the security is for the benefit of the company, the members of the company should be asked to pass a special resolution, directing that the security be given. It is prudent to require that the special resolution should be passed unanimously by members of the Company in general meeting. A written resolution signed by all the members of the Company would also be sufficient.

Solvency of the Company

In addition, the directors of the company and the bank being granted security should require comfort that the company is solvent and will remain solvent immediately after the security is given.

The dangers for the bank, if the company is not solvent immediately after the security is given are:

- (i) the security may be treated as amounting to a preference under section 239 of the Insolvency Act 1986; and
- (ii) the security may be treated as being a transaction at an undervalue under section 238 of the Insolvency Act 1986.

For the Directors to be satisfied that the company is solvent they need to be satisfied that:

- (i) the company's assets exceed its liabilities at the date the financial assistance is given; and
- (ii) the company will continue to be able to pay its debts as they fall due for the following 12 months.

Where the solvency of the company may be in doubt, it would be prudent to ask for the auditors to confirm the solvency of the company.

Capital Maintenance

The transaction must not be an unlawful reduction of capital. The prohibition of financial assistance forms one part of the maintenance of capital concept that prevents a company from unlawfully reducing its capital by returning assets to shareholders other than as permitted by legislation. The case that established this rule is *Trevor v Whitworth [1887]*. This case gives rise to the concern that the common law prohibition of financial assistance is resurrected by the repeal of ss151-158 of the 1985 Act. However, to deal with this concern, the saving in paragraph 54 of Schedule 4 to the fifth Commencement Order of the 2006 Act ensures that no common law restrictions on financial assistance are resurrected by the repeal of the relevant sections of the 1985 Act.

The rule of law derived from *Trevor v Whitworth* is, however, far wider than the prohibition on financial assistance in the 1985 Act. Thus, in certain specified cases, transactions previously prohibited by the 1985 Act will remain prohibited by the common law under the wider principles derived from the case law. The explanatory notes to the fifth Commencement Order give the specific examples practitioners must be aware of:

- A company with no (or insufficient) distributable reserves makes a gift of money to a shareholder with which to purchase further shares in the company.

This transaction is still prohibited as it would result in an unlawful reduction of capital of the company.

- A company with no (or insufficient) distributable reserves makes a loan to a shareholder with a view to the shareholder purchasing further shares in the company. Meanwhile, the company is aware when the loan is made that the shareholder has no reasonable prospect of repaying the loan, so that the company would have to make an immediate provision in respect of the loan.

This practice is still prohibited on the grounds that it gives rise to an unlawful reduction of capital.

In the case of an upstream guarantee the key question is whether the company needs to make a provision in its accounts. If it does not, there is no capital maintenance issue. If it does, the company can only enter into the transaction if it has sufficient distributable profits to cover the amount of the provision.

Conclusion

Whilst the abolition of the prohibition of financial assistance in private companies is welcomed, as it will rid us of an unnecessary procedure in some cases, there are still risks for the unwary.

It would, therefore, be wise for banks, in particular, to formulate a policy on the procedures that they require to be satisfied to establish the solvency of the borrower to minimise the risk of the security being invalidly given or being subsequently set aside.

This may give rise to an informal practice which is similar to the “whitewash” procedure and which some have dubbed “son of whitewash”. However, initial indications are that this has not been the case, so transactions have been simplified and costs reduced, all welcome developments.

New Capital Reduction Procedure

From 1 October 2008, a private company will have a new means of reducing its share capital. There are various reasons why a company may wish to reduce its share capital. For example, a company may have a large accumulated loss as a result of poor historic performance. Although the business may be expected to be profitable in the future, the company would be prevented from paying dividends to shareholders in future because of the accumulated deficit on its profit and loss account. In these circumstances, the company may want to reduce its share capital or share premium account and set off the reserve arising on such reduction against the accumulated loss. This will reduce the accumulated deficit and enable it to pay dividends out of future profits. This is an issue often encountered by venture capital back technology companies where a company may take many years to become profitable.

Section 641 of the Companies Act 2006, introduces a new procedure whereby a private company may by special resolution reduce its share capital. The special resolution must be supported by a solvency statement signed by each of the directors.

The new procedure is a quicker and cheaper alternative for private companies to the court approved procedure for a share capital reduction (although the court procedure still remains).

The new procedure is as follows:

- The directors make a solvency statement in the prescribed form. This will confirm the solvency of the company both on the date of the statement and during the year following that date. A copy of the solvency statement must be sent to members.
- The shareholders pass a special resolution reducing the share capital within 15 days of the date of the solvency statement.
- The company must prepare a memorandum of capital containing details of the share capital as reduced.
- All the directors must swear a statutory declaration that the procedural requirements have been complied with.

The directors must have reasonable grounds for making the solvency statement, as failure to do so is a criminal offence punishable by a fine and/or imprisonment. The reduction takes effect upon the resolution reducing the share capital being registered by the Registrar of Companies.

It is not yet clear exactly what directors should do in order to show that they had “reasonable grounds” in forming the opinions expressed in the solvency statement. However, the Department for Business Enterprise and Regulatory Reform (formerly the DTI) has suggested that it is unnecessary for the solvency statement to be supported by an auditor's opinion. Although the directors may take the view that they require the additional comfort of an auditor's opinion in circumstances where the company's solvency may be in doubt.

A company is insolvent if it is unable to pay its debts as they fall due or if the value of the company's assets is less than the amount of its liabilities taking into account its contingent and prospective liabilities. When determining the amount of the company's assets and liabilities reference should be had to the company's accounting records.

In order that the directors are able to swear a solvency statement they must do so by reference to the most recent audited accounts and up to date management accounts of the company as well as cash flow forecasts for at least the next twelve months and their knowledge of the

company's actual and prospective trading position. These documents should be considered by the directors in a board meeting and the minutes should record the basis on which the directors believe the company is solvent.

It is strongly recommended that the directors should only swear a solvency statement after having taken appropriate professional advice from the company's solicitors and accountants.

Currently, under the Companies (Reduction of Share Capital) Order 2008 No. 1915, a reserve arising from a reduction of capital using the new procedure may be treated as a realised profit when calculating whether a company has sufficient distributable reserves to make a distribution. The new procedure cannot be used to reduce the share capital of the company to nil.

This new simplified procedure for private companies is to be welcomed and is likely to prove popular with companies that have an accumulated deficit on their profit and loss accounts and wish to be able to pay dividends in the future.