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### **Companies Act Implementation**

The Third Companies Act 2006 Commencement Order (SI 2007/2194 "The Companies Act 2006 (Commencement No. 3, Consequential Amendments, Transitional Provisions and Savings) Order 2007") comes into force with effect from 1 October 2007. The main implications are:

- ***Resolutions and Meetings***

Sections 29 and 30 (Resolutions and Agreements affecting a company's constitution) and most of Part 13 (Resolutions and Meetings) are being brought into force.

The major change is in relation to written resolutions of private companies (see below).

Also, all resolutions, minutes of all general meetings and records of decisions made by a sole member (which must now be provided to the company in accordance with section 357) must now be kept for at least 10 years from the date of the resolution, meeting, or notification and be available for inspection.

- ***Directors Duties***

Most of Part 10 is being brought into force including the sections 170 to 174 codifying the principal duties of directors (see below) covering inter alia:

- duty to act within powers
- duty to promote the success of the company
- duty to exercise independent judgement, and
- duty to exercise reasonable skill, care and diligence

However, sections 175 to 177 codifying the duties to avoid conflicts of interest, not to accept benefits from third parties, and to declare any interest in a proposed transaction will not be brought in until 1 October 2008. This delay will give companies time to make any appropriate changes to their Articles – for example to allow independent directors to authorise a director to continue acting notwithstanding a potential conflict.

- ***Directors Appointment***

Section 160 is being brought into force which requires there to be a separate vote on the appointment of each director to a PLC unless this restriction has been unanimously waived by the meeting at which the resolutions are being considered. Any resolution passed in breach of this regulation is void.

- ***Transactions with Directors***

Sections 188 to 226 are brought into force. These largely replicate the existing rules on substantial property transactions between companies and their directors, loans to directors, payments to directors for loss of office and long-term service contracts, although changes have been made to make the rules more accessible and consistent, and to remove a number of inconsistencies.

The main changes are:

- All companies will be able to make loans to their directors if, after full details have been provided, the loan is approved by shareholders. At present such loans are generally prohibited, subject to various exceptions.
- Companies will be able to enter into transactions that would currently fall within section 320 of the 1985 Act (substantial property transactions with directors and their connected persons) before shareholder approval has been obtained, as long as the transaction is made conditional on such approval.
- Shareholder approval will be required where a company proposes to make a payment to a director in compensation for loss of his employment as a director of the company (not just for loss of his office as a director) which goes beyond his existing contractual entitlement.
- The complex rules in section 346 of the 1985 Act determining which persons are “connected” to a director for these purposes have been extended to catch a director’s civil partner and adult children and step-children, the director’s parents, a person who lives with the director ‘as partner in an enduring family relationship’, and any children or step-children under 18 of such a person who are not also the director’s children or step-children. This extended definition flows into the provisions that determine whether a director is connected with, or controls, a body corporate and follows the Insolvency Act definition.

- ***Exercise of members’ rights***

Sections 145 to 154 are being brought into force. These sections have no counterpart in the 1985 Act and are designed to make it easier for investors who hold quoted shares through nominees or other intermediaries to exercise voting and other rights attaching to their shares, principally by allowing a registered member to nominate one or more indirect investors to receive a copy of all notices and circulars the company sends its members, and copies of all reports and accounts (“information rights”).

All companies can provide in their Articles for one or more indirect investors to exercise some or all of a member’s rights, including the right to vote and to appoint proxies.

Also, from 1 October 2007 nominee investment operations will be able to nominate a person to enjoy information rights, but companies have until 31 December 2007 to act on a nomination.

Section 152 allows a person who holds shares on behalf of a number of different people to exercise those rights so as to reflect the wishes of the underlying third party who is interested in those shares and parcels of shares held by such a nominee may be voted in different ways or some voted and others not voted at all.

- ***Inspection of Register of Members and Register of Members’ interests***

Sections 116 to 119 are being brought into force. Once a company has filed an Annual Return made up to a date after 30 September 2007, anyone who wants to inspect and copy a company’s Register of Members or Members’ Interests will have to tell the company what the information will be used for and who it will be passed to. If the company can persuade a Court that this is not a proper purpose it may obtain permission to reject that particular request and any similar ones made in the future.

ICSA published guidance on this and an improper purpose might include:

- any representation or communication to members that the company is concerned would threaten, harass or intimidate them
- offers related to securities
- performing credit or ID checks on individual members
- any other purposes, for example, commercial mailings, not related to the members in their capacity as members of the company or to exercise their shareholders rights.

Also, companies need to consider members' data protection rights when responding to requests for access.

A charge of £3.50 for each hour or part thereof can be charged for inspection of the Register and index of members' names. The fees chargeable for copies of the Register of Members or Register of Interests in Shares are:

- £1 for each of the first 5 entries
  - £30 for the next 95 entries or part thereof
  - £30 for the next 900 entries or part thereof
  - £30 for the next 49,000 entries or part thereof
  - £30 for the remainder of the entries
- Plus reasonable costs for delivering the copies

Annual Returns of unlisted companies will not have to include shareholder addresses; those of company's whose shares are traded on an EU regulated market will only need to disclose the addresses of shareholders holding 5% or more of any class of share at any time during the year in question. Whilst this will ensure current details are not on public record, information already filed at Companies House will continue to be available.

- ***Derivative Actions***

Part II has been brought into force. It sets out the circumstances in which a member can bring a claim on behalf of the company against a director in respect of his or her negligence, default, breach of duty or breach of trust. These provisions are likely to make it slightly easier for members to bring proceedings, although a member must first obtain court permission to bring a claim.

- ***Content of Director's Report***

Section 417 is brought into force, which effectively reintroduces the OFR for quoted companies for financial years commencing on or after 1 October 2007.

- ***Appointment of Auditors – private companies***

Sections 485 to 488 are being brought into force. These sections take account of the fact that companies will no longer have to lay the accounts before the members in general meeting. Section 386 of the 1985 Act relating to the election to dispense with annual appointment of auditors of private companies is repealed and for accounting periods commencing on or after 1 October 2007 auditors will need to be reappointed annually by ordinary resolution before the end of the period of 28 days beginning with:

- the end of the time allowed for sending out the accounts and reports for the previous financial year; or
- if earlier, the date on which those accounts and reports were actually sent out.

Newly appointed auditors do not take office until the previous auditors have ceased to hold office.

The section dealing with the appointment of auditors for a public company comes into force on 6 April 2008.

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### **Changes to Written Resolutions**

Under the Companies Act 1985 a written resolution could only be passed by a private company if it is signed by all shareholders entitled to vote on the resolution.

The changes, effective from 1 October 2006, are set out in Sections 288 to 300 of the Companies Act 2006.

As currently, only private companies can use the procedure and written resolutions cannot be used to remove a director or an auditor before the expiry of their term of office.

However, unanimity will no longer be required to pass a written resolution. The 2006 Act introduces the concept of ordinary written resolutions (which can be passed by the agreement of shareholders holding more than 50% of the voting rights) and special written resolutions which requires the agreement of shareholders holding 75% or more of the voting rights. A special written resolution is required where a special resolution is needed under the Act.

The main features of the new procedure are:

- a written resolution can be proposed by the directors or by members holding 5% of the voting rights (or a lower percentage if specified in the Articles). A company can apply to the Court for permission not to circulate a written resolution on the grounds that the shareholders are abusing their rights.
- Where a proposal has the support of the requisite percentage of members (see above) the proposers can require the company to circulate the resolution together with a statement of up to 1,000 words.
- a resolution can be communicated to members in hard copy or electronic form or by means of a website, depending on how the company communicates with its members. The form of the written resolution can be sent to all members simultaneously or by circulating the same copy of the resolution to members in turn, or by using a combination of the two.
- a written resolution does not have to be physically signed by shareholders. A member is treated as signifying their agreement to a resolution when the company receives from them an authenticated document (in hard copy or electronic form) identifying the resolution and indicating their agreement. Once signified in this way, agreement to a written resolution cannot be withdrawn.
- the resolution lapses if it is not passed before the end of the period specified in the Articles (or 28 days from the circulation date if no period is specified).
- The company must circulate a statement with the resolution informing the members how to signify agreement and the date by which the resolution is to pass if it is not to lapse.
- There is no longer a requirement to send a copy of the resolution to the auditors.

The Act removes the right of Companies to follow other procedures for written resolutions laid down in the Articles. However, given the flexibility of the above procedures this should not cause any problems.

The Act also requires sole members of a company to notify the company of all decisions made where that decision is one that may be taken by the company in general meeting and has effect as if agreed by the company in general meeting. This means that decisions taken by sole members must be formally recorded and the records kept for 10 years and be open to inspection.

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### **Directors Duties**

For the first time, the principal duties owed by directors to their company have been set out in statute, making them clearer and more accessible. The statutory duties will replace the common law duties of directors on which they are based, and come into force on 1 October 2007 (except those relating to conflicts of interest, acceptance of benefits and declaring interests in transactions, which will come into force on 1 October 2008).

### ***Promoting the success of the company***

The most controversial aspect of the new Act is section 172, which replaces the fiduciary duty to act in good faith in the best interests of the company. The new 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 the members as a collective body: not just the majority shareholders, or any particular shareholder or section of shareholders. According to statements made in Parliament, the success of the company means what the members collectively want the company to achieve. For a commercial company, this will usually mean long-term increase in value; for charitable and community interest companies, the attainment of the objectives for which the company was established.

The duty requires the director to have regard (amongst other matters) to six specified factors:

- the likely consequences of any decision in the long term
- the interests of the company's employees
- the need to foster the company's 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
- the need to act fairly as between members of the company.

The Government says that this is a radical departure and that it reflects a cultural change in the way that companies conduct their business – that it is now recognised that pursuing the interests of shareholders and embracing the wider responsibilities flagged in the list of factors are complementary purposes, not contradictory ones. The intention is that no director has any excuse for thinking that acting in the interests of the company's members necessarily precludes acting in the interests of those who depend on the company, like its employees and its supply chain.

The decision taken by a director and the weight given to the factors are a matter for his good faith judgement. It is therefore fundamentally a subjective matter, although there is an element of objectivity in that all directors must exercise reasonable skill, care and diligence. The Government says that directors must give the factors – and any other relevant factors – proper consideration, and not merely pay lip service to them. To a large extent, this is what any responsible board would do as part of its decision-making. Section 172 can be seen as a means of improving the processes of boards, rather than imposing an additional substantive burden. But the duty will apply to everything that a director does as a director, not just his participation in formal board meetings.

Where an urgent decision is necessary, the requirements of section 172 should not be read as preventing a decision being made until (for example) formal reports have been commissioned – it is simply the case that the directors must do their best in the time that is available.

Not all the factors will always be relevant, and sometimes one factor may be irreconcilable with another one: investing in new technology, for example, may be better for the environment but cause job losses. The obligation is not to ensure that the company achieves a positive score on each factor, but to think about them when deciding what course will best promote the company's success. Where factors conflict with each other, or with what the directors consider to best promote the company's success, it is legitimate to discount a particular factor or give it less weight – as long as it has been thought about in relation to the particular circumstances.

It will be a fundamental element of discharging a director's duties that he is aware of the factors. Processes may need to be overhauled and training given – and not just to directors. Where directors receive briefing papers and similar background material prepared by others, the individuals compiling these papers should also be thinking about the matters that directors may need to take into account.

There has been some debate as to whether board papers should specifically refer to each of the 6 factors referred to above so that directors are seen to have addressed all the relevant issues. Current thinking is that this will not be necessary but that, in appropriate cases, directors will have to show (by reference to more than boilerplate wording in minutes) that they have considered all the relevant factors in satisfaction of the more general duty to promote the success of the company.

Board papers and minutes may well need to be more detailed than at present to achieve this objective.

***Other fiduciary duties***

A director must also:

- Act in accordance with the company's constitution (which for these purposes includes all lawful shareholder and board resolutions), and only exercise powers for the purposes for which they are conferred
- Exercise independent judgement, and not fetter his discretion except as the company's constitution (in its extended definition) permits or pursuant to an agreement that was considered to promote the success of the company when it was entered into. This largely follows the Insolvency Act tests.

From 1 October 2008 he will also have to:

- Avoid conflicts of interest
- Not accept benefits from third parties
- Declare his interest in any proposed transaction or arrangement.

Finally, as a result of these changes it may be sensible to review the company's Directors & Officers Insurance policy and consider whether this should be complemented by an appropriate indemnity in favour of the directors of the company.

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**Effect of recent changes in reporting directors interests in shares of private companies and AIM companies**

***Private companies***

Although there is now no company law requirement to include directors' shareholdings in the annual report, oddly there is still a requirement to report on whether the highest-paid director exercised options or received shares under a long-term incentive scheme during the period under review.

This is a bizarre result – readers of private company accounts will be able to see whether the highest-paid director received shares under an option or award, but not the actual amount and – crucially, given the changes made in company law – not whether the directors actually hold any shares.

***AIM companies***

AIM companies have slightly more onerous requirements under company law than private companies in terms of what they have to put in their directors' report about directors' interest. They just have to report the total amount received by all directors by way of gains (in the case of the exercise of share options) or shares/cash (in the case of long-term incentive awards).

Interestingly, there is no requirement in the AIM rules for annual reports to include directors' options or long-term incentive awards as directors' shareholdings, or apportion the realised gains between directors. However, although AIM companies will no doubt continue to report this extra information voluntarily in their annual reports, it may be that it is only a matter of time before the AIM rules are changed to make this mandatory in case a company chooses to challenge market practice on this point.

AIM companies are required under the AIM rules to announce any changes in their directors' (and certain connected persons') holdings as and when they occur – although only insofar as the company has the information.

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**Money Laundering – Recent Court Case**

A recent Jersey case (*Attorney General v Caversham Fiduciary Services Ltd*) shows that authorities are stepping-up actions for breaches in anti-money laundering compliance. The case involved a one-off breach in the Regulations by a Trust Company and arose when one of the Trust Company's directors was approached to set up a discretionary trust by a solicitor in England. He said that a Mr Stevens had been appointed as attorney for a Mr Lee. The latter, who was a non-UK resident, and who had recently received funds from the sale of a sauna business, wished to hold them through an offshore trust. The solicitor sent through documents to identify the attorney, but not the ultimate client.

A few days later, £850,000 was sent from the solicitor's account to the trust company and just two days after this, the solicitor requested the trustee to pay £825,000 to four entities, none of which had any connection to the trust. The trust was established, with the attorney as the sole beneficiary, and the next working day, the payments out were made. This failure to adhere to 'know your client' procedures came to light during a routine inspection by the Jersey Financial Services Commission (JFSC) nearly two years later.

Caversham's defence was that a single breach in procedures does not constitute an offence. This defence failed both in the original case and on appeal. There was no custodial sentence in this case purely because there was no laundering of any proceeds of crime.

This case is likely to be the precursor of similar actions by the FSA on the mainland.

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### **Phoenix Companies – Amendment to Insolvency Rules**

An amendment has been made to the Insolvency Rules 1986 to remedy the problems caused by the Court of Appeal decision in *Churchill v First Independent Factors and Finance Limited* regarding the use of prohibited names by Phoenix companies.

Subject to various exceptions, Section 216 of the Insolvency Act 1986 prohibits a person who was a director or shadow director of a company within 12 months of its entering into insolvent liquidation from acting as a director of another company which has a name which is so similar to the name of the company in liquidation as to suggest an association with that company ('a prohibited name'). It also prohibits such a person from carrying on business under a prohibited name otherwise than by a company.

One of these exceptions is the giving of notice to creditors pursuant to rule 4.228 of the Insolvency Rules 1986 where a successor company acquires the whole or substantially the whole of the business of the insolvent company. However, in *Churchill v First Independent Factors and Finance Limited* the Court of Appeal held that the relief afforded by giving a notice under rule 4.228 is of no effect if the individual is already a director of the successor company at the time the notice is given, but only if the notice is given before the individual becomes a director of the successor company.

The decision gave rise to a number of difficulties, which have now been addressed by the amendment of Rule 4.228 which applies where arrangements for the acquisition of the business from the insolvent company are entered into on or after 6 August 2007. Where an arrangement has been completed before that date, the former rule will continue to apply.

The new Rule 4.228 makes provision for a director of an insolvent company which goes into insolvent liquidation to act as a director of a company with a prohibited name where that company acquires the whole or substantially the whole of the business of the insolvent company, provided certain notice requirements are complied with. Unlike the previous rule, it also provides for such a person to carry on business under a prohibited name other than by way of a company, subject to the same requirements.

In the new rule the notice requirements have also been expanded. Notice must be published in the Gazette and given to all creditors whose name and address is known to the director or could be ascertained by him on making reasonable enquiries. The notice must be in a new form, Form 4.73, and

may be given before the company enters into insolvent liquidation, for example where it is in administration or administrative receivership and may go into liquidation later. In such cases where the company is not in insolvent liquidation, notice can be given where the director of the insolvent company is already a director of the acquiring company. However, notice must always be given before a director acts in a way that would be prohibited by Section 216. The effect of the rule is that, although the person concerned may act as a director of the acquiring company *before* the notice is issued, the prohibited name cannot be used until *after* the notice has been given and published.

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### **Granting Access to Audit Working Paper to Successor Auditors From 6 April 2008**

One of the changes in the Companies Act 2006 coming into force is in respect of audit appointments made on or after 6 April 2008. From this date there will be a requirement for a predecessor auditor to, if requested in writing by their immediate successor, to allow the successor access to all relevant information held by them in respect of the last audit report signed by them.

Relevant information is the information in the audit working papers compiled to comply with auditing standards. Any information obtained by the successor is for the purposes of its audit and must not be disclosed to a third party unless required to do so by a legal or professional obligation.

Draft guidance has been issued stating that if a successor auditor asks their immediate predecessor auditor in writing for access to its audit files, then this should be granted. How this access is arranged is for the two auditors to agree, but it should be on a timely basis. There is no obligation to allow the copying of audit working papers but it would be usual to allow copying of extracts of the books and records of the audit client that are contained in the audit working papers.

This regulation only applies to the most recent auditor. It does not allow the current auditor to seek access to the audit working papers of other auditors who have audited the entity in the past. It also only applies to the latest audit completed by the predecessor together with any subsequent review conducted by the predecessor auditor in accordance with guidance published by the APB in relation to published interim reports of results. This is consistent with the approach in ISA 510 (opening balances) and ISA 710 (comparatives). The predecessor auditor should be prepared to assist their successor by providing oral explanations to assist the latter's understanding of the audit working papers.

This regulation does not create any new duties or obligations between the predecessor auditor, the successor auditor or the audited entity. It would be usual for this matter, and the detailed arrangements for access, to be confirmed in writing by an exchange of letters between the two auditors and the audited entity. Guidance on suitable letters will be issued in due course.

The successor auditor should refuse to accept an engagement, such as to act as an expert witness, from the audit client or a third party, where the engagement would involve the successor commenting on the predecessor's audit working papers. This does not prevent the successor auditor discussing information contained in the predecessor's audit working papers as a necessary part of its audit work.

These arrangements are separate to those set out in the Institute's Code of Ethics on procedures to be followed before accepting a professional appointment which continues to apply.

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### **Depreciation in stock**

In recent cases, *HMRC v William Grant & Sons Distillers Ltd* and *Small v Mars Ltd*, the House of Lords determined that if an element of the depreciation charged in respect of fixed assets is carried forward as part of the cost of stock then it is only the net depreciation that has to be added back and not the gross.

HMRC has changed its guidance in its Business Income Manual (BIM 33190) accordingly. This guidance indicates that we will have to consider what element of the depreciation that has been added back in previous years relates to stock that has not yet been sold. The current year's taxable profit will have to be reduced to reflect that amount.

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**Charities Act 2006 – Changes to the accounting and auditing framework**

Even after the increases in the audit threshold for charitable companies for accounting periods beginning on or after 27 February 2007, there are significant inconsistencies between the external review requirements for small charitable companies and small charity trusts. These inconsistencies are to be removed from 1 January 2008.

For accounting periods beginning on or after this date the regulations will be the same for all charities. As a result:

- The income threshold below which no external scrutiny is required will be £10,000 for all charities (i.e. for both charitable companies and trusts).
- If income exceeds £10,000 and total assets do not exceed £2.8M, the charity may elect for an independent examination of the accounts instead of an audit. If gross income exceeds £250,000 the independent examiner must be a member of a recognised professional body.
- If income is more than £500,000 or if income is more than £100,000 and the total assets exceed £2.8M, the charity must be audited.

The greatest impact is likely to be for small charitable companies who were previously exempt from any form of assurance review if their income was less than £90,000.

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