issue 10

serle quarterly

the newsletter of serle court

"I am delighted to introduce this edition of Serle Quarterly, which addresses issues arising in relation to the Companies Act 2006. From rather more humble beginnings, the new Act has undertaken a codifying aim, which has resulted in one of the largest pieces of legislation ever passed by Parliament.

The new Act introduces numerous changes to the current regime in Company Law. Of particular interest are the nuances introduced in the areas of directors' duties and derivative claims. These matters are all explored in this issue, and John Whittaker ponders the implications for LLPs."

Victor Joffe QC

directors duties

The new regime under sections 170 to 177 of the Companies Act 2006 is explicitly intended to be a statutory codification of the equitable principles of fiduciary duties and the common law of negligence as they apply to directors. It is plain, however, that these sections are considerably more than a mere codification of existing law.

Beginning at the beginning, section 170 of the new Act secures two fundamental features of the new regime. The first, articulated in section 170(1) is that "The general duties specified in sections 171 to 177 are owed by a director of a company to the company". Hence, it remains the case that directors' general duties are not owed to anyone other than the legal person that is the company and that only the company can sue for breach of such duties.

Sections 170(3) and (4) then articulate a fundamental aspect of the new regime which is relatively novel and not without some complexity. Sub-para (3) makes clear that the new principles are a statutory replacement of the old equitable and common law duties: the new duties are to "have effect in place of those rules and principles". However, sub-para (4) then seeks to make clear that the new regime is not to be regarded as a kind of "year zero". On the contrary, in the first place the new duties as to be "interpreted and applied in the same way" as the relevant common law rules and equitable principles and, secondly, that "regard shall be had" to those rules and principles "in interpreting and applying the general duties". These phrases are not wholly free from difficulty. In the first place, it is not in accordance with the usual principles of statutory interpretation for courts to approach the interpretation of a statute in the same manner as they approach case law precedents from which they seek to determine a ratio or a relevant dictum. Yet here, that appears to be what is intended.

Secondly, the statutory duties (in particular, section 172) do not accord linguistically with any existing duties. Section 172(1) provides that a director must act in the way "he considers, in good faith, would be most likely to promote the success of the company". There was no such duty at common law or in equity. The nearest equivalent

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to it is the duty to act *bona fide* in the interests of the members as a whole.

Nonetheless, it does appear that two principles are intended to be enshrined in sub-para (4). Firstly, regard “shall” be had to common law authorities on directors’ duties in interpreting the new statutory duties. Secondly, subsection (4) is “intended to enable the courts to continue to have regard to developments in the common law rules and equitable principles applying to [these] other types of fiduciary relationship” (the Attorney-General in the Lords on 6 February 2006). Hence, it appears, it will be legitimate for judicial development of principles applicable to, eg, trustees to inform the content of directors' duties.

Section 172 is the most significant change in the new regime on directors’ duties. It imposes an obligation on 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 whole.”. And in doing so, he must have regard, amongst other matters, to six matters, being 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” and “the need to act fairly as between members of the company”.

This new language represents a pretty fundamental change in the previous regime which was almost solely concerned with the direct financial interests of the members alone as they appeared to the directors. What the new section 172 encapsulates might be thought of as a classic piece of New Labour triangulation, between the former orthodoxy and the “pluralist” aspirations of its left wing, whereby shareholders would have been only one of a number of constituencies, such as employees, in whose interests the board would have been obliged to manage the company. The halfway house encapsulated by section 172 is the product of what is styled “enlightened shareholder value”, which contends that the “enlightened” shareholder will not be interested in just making as much money as quickly as possible, but will see financial advantage in caring about workers, suppliers, trees and the like.

But, it is of course the case only that the board must show that it has considered the relevant factors and reached a *bona fide* (not a reasonable) determination that it should act as it decides to. Given the Courts’ historic and continuing reluctance to second guess management decisions, this will be a relief to the judiciary and it seems likely that Chancery Judges will be very uncomfortable with the general notion that they have to investigate complaints about insufficient consideration being given to environmental concerns etc.

Overall, therefore, it is clear that the new regime as it applies to directors' duties, whilst in part a codifying exercise, is both more and less than that overall. Less, because it explicitly requires that the whole corpus of case law, not merely historically built up in relation to common law and equitable duties on directors, but also that in relation to analogous areas of law as they continue to develop, are to be used to interpret and apply the new statutory duties. More, because section 172 in particular marks an attempt to change the language in which directors' duties are cast and, possibly but uncertainly, the conceptual underpinnings of business in the UK.

Giles Richardson has wide experience of disputes concerning directors' and other fiduciaries' duties.

indemnification and ratification

Given the many changes to the law made by the Companies Act 2006 which may leave the corporate practitioner feeling somewhat overwhelmed, it is reassuring to learn that the substantive law relating to indemnification, the power of the Court to grant relief, and ratification has not changed to any significant degree.

In terms of indemnification, sections 232-238 of the Companies Act 2006 for the most part restate the previous provisions in sections 309A-309C of the Companies Act 1985 as introduced by section 19 of the Companies (Audit, Investigations and Community Enterprise) Act 2004.

The effect of section 232 is to render void any provisions in the articles or in a contract which purport to exempt a director from liability (in whole or part) for any negligence, default, breach of duty or breach of trust in relation to the company. However section 232(4) makes it clear that the articles can contain provisions dealing with conflicts of interest. Furthermore section 233 provides that a company may purchase and maintain insurance for the director of that company or an associated company in respect of these liabilities.

As regards third parties, section 234 permits a company to indemnify directors in respect of liabilities incurred to a person other than the company or an associated company. Finally section 235 excludes the effect of section 232 in relation to provisions indemnifying directors of a company that is a trustee of an occupational pension scheme incurred in connection with the company’s activities as trustee of the scheme.

Section 1157 of the Companies Act 2006 reproduces section 727 of the Companies Act 1985 and confers upon the Court an identical power to relieve a director of liability for negligence, default, breach of duty or breach of trust where he has acted honestly and reasonably and ought fairly to be excused.

Prior to the Companies Act 2006 there had been no codification of the procedure by which directors’ breaches of duty could be ratified. The position at common law was that a director who was also a member could vote in favour of the ratification of his own acts so long as he acted in good faith and the resolution for ratification would be valid even if it was only passed by the inclusion of the director’s votes *(North-West Transportation Company v Beatty* (1887) 12 App Cas 589).

In codifying the procedures for ratification, the new section 239 of the Companies Act 2006 continues to permit directors who are members, and members who are connected with him, to attend the meeting, be counted in the quorum and participate in proceedings. However *per* section 239(4) the ratification resolution will only be passed if the necessary majority is obtained disregarding votes in favour which are cast either by the director or any member connected with him as defined by sections 252 and 254.

As noted above, the provisions relating to ratification do not make any change to the substantive law. Thus to ascertain what acts may or may not be ratified reference will still need to be made to the pre-existing position at common law (in this regard see also section 239(7)).

Matthew Morrison has a broad corporate and insolvency practice and is Junior Counsel to the DTI for Directors’ Disqualification hearings.

conflicts time to relax a little

The rules governing directors' conflicting interests and personal profits are currently contained in a diverse selection of common law and equitable principles, with certain statutory rules. The incremental and case-driven development of the common law and equitable principles has led to different approaches by the courts and commentators in terms of analysis and classification. The Companies Act 2006 ("the 2006 Act") provides a more structured framework to the area. As part of its stated intention to avoid the unnecessary inhibition of entrepreneurial activity (and in order to reflect the realities of current corporate constitutions) it provides for a slight relaxation in certain respects of the basic rules.

One of the key features of the structure of the new regime is the separation of the principle prohibiting conflicts of interest as it applies to transactions with third parties (section 175) and transactions with the company (sections 177 and 182). In respect of transactions with third parties, section 175 enshrines the basic "no-conflict" rule in the terms of the classic dictum in *Aberdeen Ry Co v Blaikie* ((1854) 1 Mac 461, 471-472). Directors are under a duty to avoid situations where their interests may conflict with those of the company. This principle applies specifically to the exploitation of any property, information or opportunity belonging to the company and continues to apply to former directors in respect of matters of which they became aware while in office (with a certain amount of flexibility in application in respect of the latter).

The principal change to the current rules in respect of transactions with third parties is in the basic principle relating to authorisation. The current position at common law requires the consent of the company in general meeting, although in practice a company's Articles almost invariably replace this with a requirement of disclosure to the board. Section 175(4)(b) provides (subject to compliance with the authorisation requirements and specific provisions to the contrary) that the duty is not infringed if the matter has been authorised by the directors. Thus the current practice metamorphoses into the general rule.

Section 176 precludes directors from accepting benefits from third parties which are conferred by reason of their office or their acts or omissions as a director. It principally reformulates the duty not to accept bribes or secret commissions applicable to fiduciaries generally. Since there is no provision for board authorisation in respect of such a benefit, the interrelation with section 175 will be of particular interest.

So far as transactions with the company are concerned, the 2006 Act separates the treatment of proposed and existing transactions (sections 177 and 182 respectively). In respect of proposed transactions, section 177 again implements what is strictly a relaxation of the current basic position, but in reality is little more than a codification of the approach generally adopted in a company's Articles (by way of relaxation of the restrictions at general law which require authorisation by the general meeting). Under section 177 a director does not require authorisation (of the board or the members), but must declare his interest to the board. In a further nod to practicality, there is no duty to declare an interest *(inter alia)* if the other directors are already aware of it or ought reasonably to be so aware, or if the director is not aware of it and it is not something of which he ought to be aware.

Tim Collingwood frequently acts in cases involving allegations of breaches of duty by directors.

…and there are also LLPs

Limited liability partnerships are corporate entities. Although not a company, an LLP has many affinities with a company; and its governing legislation includes, by way of statutory instrument made under the LLP Act 2000, parts of the Companies Act 1985 with modifications. These modifications are both general (eg "company" includes LLP and "director" includes member) and specific (eg a substituted section 364 as to the contents of the annual report). The Insolvency Act 1986 is similarly applied with modifications. The statutory instrument applying these Acts states the modifications (33 pages for the Companies Act): the reader then creates the resulting version of the applicable Act for himself.

The advent of a new Companies Act, therefore, means the likelihood of a newly modified 2006 Act for application to LLPs. "Likelihood" (rather than certainty) because it would be possible, in principle, to continue the modified 1985 Act as applicable to LLPs. This is one of the issues on which the DTI is presently consulting. The case for staying in step with current companies legislation, and so moving to a modified 2006 Act for LLPs, is, however, overwhelming; and it seems reasonable to assume that the DTI will follow this course. On this basis, the new Companies Act will apply to LLPs as well as to companies, and there will be a new statutory instrument containing the relevant modifications to the Act for this purpose. It is to be hoped that the statutory instrument will itself now contain the authorised version of the resulting applicable legislation.

As to implementation of the modified 2006 Act for LLPs, the aim of the DTI is that, with one exception, all the provisions in the 2006 Act to be applied to LLPs should come into effect together, namely at the same time as the main implementation of the Act for companies in October 2008. The one exception relates to the reduction of the filing deadline for accounts and reports from 10 months to 9 months, and the proposed changes to the late filing penalties regime (sections 441-453). For ease and economy of administration at Companies House, it is intended that these provisions will be implemented at the same time (prior to October 2008) for both companies and LLPs.

There is at least one new regime for companies in the 2006 Act that could, and may well, be applied to LLPs. This is the statutory codification of derivative claims (sections 260-264), where a minority seeks to take action for the benefit of the corporate body against a wrongdoing, and controlling, majority. The principle of the present derivative action is as equally applicable to LLPs as it is to companies, and it may be sensible to have both forms of entity governed in this respect by the same statutory provisions.

And there is one area of possible implementation (or not) of the 2006 Act which may cause some controversy. At present overseas LLPs operating in England (eg US law firms) do not share the disclosure obligations in the UK of domestic LLPs. And for the most part they do not have these obligations in their home territories either. There are some strong views as to whether or not this lack of UK obligation for foreign LLPs trading here should continue.

John Whittaker is the co-author of *The Law of Limited Liability Partnerships* (2nd edn 2004) and advises regularly on LLPs.

the new statutory derivative claim

Courts are slow to interfere with companies' internal management or grapple with issues of commercial judgment. They must, however, enter the boardroom when faced with a derivative claim – a claim made by a shareholder on behalf of, and for the benefit of the company, typically for breach of duty against a director. If the derivative claim succeeds, a remedy will be awarded to the company itself, rather than to the shareholder bringing the claim on its behalf.

The Companies Act 2006 ("the 2006 Act") has revamped derivative claims and, for the first time, put them on a statutory footing. As from 1 October 2007, the 2006 Act will abolish the common law derivative claim.

Whilst a full analysis of the changes the 2006 Act will bring to derivative claims is beyond the scope of this article, some key features are summarised below.

First, the scope of those with *locus standi* to bring a derivative claim will be widened, to include a person who is not a member of the company but to whom shares have been transferred or transmitted by operation of law (eg a member's trustee in bankruptcy, or the personal representative of a deceased member's estate).

Second, the 2006 Act will remove some of the barriers to bringing a derivative claim. Unlike at common law, (i) wrongdoer control of the company will not need to be shown, and (ii) breach of duty (including negligence) by a director without any corresponding benefit to him/herself can be the subject of a derivative claim.

Third, the 2006 Act both puts on a statutory footing and widens the scope of directors' duties, and accordingly widens the scope of potential derivative claims. (The statutory derivative claim will, however, only be available against non-directors where there has been a breach of duty or otherwise actionable misconduct by the company's directors.)

Fourth, courts will be encouraged to weed out unmeritorious derivative claims by means of a new two-stage procedure for court permission to continue a derivative claim.

Finally, for the first time a member will be able to apply for permission (i) to continue as a derivative claim a claim brought by a company where the cause of action on which the claim is based could be pursued as a derivative claim, or (ii) to continue a derivative claim brought or continued by another member.

How much is the new statutory derivative claim likely to be used?

For many minority shareholders, presenting a section 459/994 petition will remain more attractive. The reasons for this include: the petitioner need not seek court permission to proceed with the petition; unfair prejudice is far more widely-drawn than actions/omissions which permit a derivative claim to be brought; ratification or authorisation by the company does not bar a petition; a petitioner need not show he/she is acting in good faith; the remedy awarded will reflect the petitioner's personal needs; and a petitioner can obtain a corporate remedy and possibly a costs indemnity order.

Shareholders will be put off by the costs (and potential costs orders) of a derivative claim without the case even going past the preliminary procedural filters – especially as the benefit of a successful action will go to the company, rather than the shareholder personally.

However, the statutory derivative claim is likely to have a role to play, especially in large public companies, where the courts are reluctant to grant a winding-up remedy or to construe the shareholder's interests as going beyond the articles in order to grant relief under section 459/994. It may also be used by ideological shareholders to put pressure on directors to be more environmentally friendly, or by vulture funds conscious of the potential ransom value of a derivative claim. How successfully courts will weed out meritorious from unmeritorious derivative claims remains to be seen.

Daniel Lightman has extensive experience of appearing in derivative claims.

chambers news

Clerking

After 44 years with Serle Court, Terry Buck is retiring from front-line clerking at the end of July. We are grateful to Terry for the huge contribution to the development and success of Serle Court which he has made over the years. Terry will not be leaving us immediately; he has agreed to stay with us for another year as a consultant.

From August the clerks' room will be led by Steve Whitaker as head clerk. Steve has been with us for over 30 years, and has been a senior clerk for the last 20. He will now have two senior clerks reporting to him, Nick Hockney and Paul Reece. Paul has recently joined us from 5 Stone Buildings and brings with him a wealth of clerking, marketing and IT experience. Nick has been a senior clerk at Serle Court for the past 18 months. Nick and Paul will be supported by two junior clerks, Daniel Wheeler and Georgina Maude. Paul Ballard will continue in clerking and will take on additional internal responsibilities. Barry Ellis will take on a co-ordinating and liaison role.

Our new clerking structure is designed to ensure that we continue to offer exceptional service. If you have any questions about the new structure please do not hesitate to contact Steve Whitaker.

Members

Since the last newsletter, Matthew Morrison and Jonathan Fowles have both been appointed to the panel of Junior Counsel to the DBERR (formerly the DTI) in Directors' Disqualification Directions hearings; Professor Michael Palmer has been made an Honorary Professor at the People's University Law School in Beijing; James Corbett QC has been appointed a deputy High Court judge in England and Wales and Kuldip Singh QC has been elected to the office of Secretary of COMBAR.

Financial Times Innovative Lawyers

This is the first year that the authoritative Financial Times Innovate Lawyers Survey has researched and ranked sets of chambers. We are delighted that Serle Court has been "highly commended". In describing Serle Court's innovation the Financial Times commented as follows:

''Boasts a "magnificent marketing machine" and is described as "extremely proactive"... The 2000 merger has allowed it to offer a genuine combination of commercial and chancery. Client service is "paramount" and "runs through the set".'

Edited by **Tim Collingwood**