

Reforms to English Company Law

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Editor's Note: *The wholesale reforms to U.K. company law described in this issue are likely to demonstrate, yet again, the dangers inherent in codifying common law principles and prescribing wholly new duties. Although the aims of consistency, certainty and accessibility are laudable, there is no getting away from the fact that lawyers end up using words to describe duties, and that when a new formulation of words is introduced there will be an initial period of uncertainty. Given present-day concerns about the role of corporations (particularly large ones) in society, the temptation to employ new ways of setting out duties was bound to overwhelm U.K. legislators, but in this instance there is little evidence that any attempt was made to resist the temptation at all. Quite what a duty to promote "the success" of a company means depends entirely on whether one is thinking of jobs, the environment, the community or (perish the thought) the interests of shareholders. U.S. advisers to U.S. individuals who are on the boards of U.K. companies should read on....*

English company law has been under review for a number of years with the aim of ensuring it is fair, modern and effective. On Nov. 8, 2006, the long-awaited Companies Act 2006 (the Act) received Royal Assent, albeit amid some confusion as to its precise form. The Act was not published until early December. Until then, practitioners and commentators had been left piecing together previous drafts and trying to make sense of Parliamentary reports of last-minute amendments.

The majority of the Act is expected to come into force by October 2008, although certain parts will commence earlier (some, for example, at press time). Further consultation will be sought on how the Act should apply to existing companies and secondary legislation will be required to support some of the Act's provisions.

This piece of legislation is not for the faint-hearted. It spans almost 1,300 sections and 16 schedules. As might be expected in

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an enactment concerning how companies should operate, there are points raised by the Act that are of relevance to the restructuring and insolvency industry—both in the United Kingdom and abroad.

Expenses of the Liquidation: Historical Position Restored



Sandy Shandro

As we have highlighted in previous columns (see the December/January 2007 issue), the priority given to insolvency expenses is likely to be a matter of interest to U.S. readers, particularly in the case of parallel filings. The

creditors had an incentive to push for liquidation rather than administration (so that their recoveries were not reduced by liquidation expenses), the new law can be regarded as further promoting the U.K.'s rescue culture.

Legislation generally changes the law prospectively, so the Act will not affect distributions that have already been made on the basis of *Leyland Daf*. However, the legislative changes will, in future liquidations, affect realisations of floating charges under debentures granted in reliance upon *Leyland Daf* (i.e., before the Act comes into force).

The Act does permit rules to be made restricting the application of the new provision to those expenses authorised by the floating-charge holder, preferential creditors or the court. How such rules will work will need to be examined closely and it is as yet unclear whether the intention is that they should come into force at the same time as the Act.

Directors' Duties

The aim of the Act is to make the law in the area of directors' duties more consistent, certain, accessible and comprehensible. In view of this, the new law introduces a statutory statement of directors' general duties that replace

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House of Lords in *Buchler v Talbot (Re Leyland Daf)* [2004] UKHL 9 held that liquidation expenses were not payable out of assets subject to a floating charge security. In so doing, the Lords overturned the position that had existed for 30 years since the decision in *Re Barleycorn Enterprises* [1970] Ch 465. The Act will restore the *Barleycorn* position so that liquidation expenses will be payable out of floating-charge assets. The legislative reversal of the House of Lords decision attracted both praise and criticism in equal measure during its conception, highlighting the difficult policy considerations inherent in insolvency law.

The new law will now ensure that the regimes for the payment of liquidation expenses and administration expenses are brought closer into line. Administration expenses were not affected by the decision in *Leyland Daf* and so have continued to be payable out of floating charge assets. To the extent that, following *Leyland Daf*, secured

existing common law and equitable rules (subject to what is said below).

One of the general duties included in the statement is a duty to act in the way a director considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole. This duty is to be carried out with regard to a series of matters, including the interests of employees and the impact of the company's operations on the community and the environment.

It is unclear how directors are to discharge their duties to consider the various competing interests when a company is approaching financial difficulties. The duty to promote the success of the company for the benefit of its members is expressed to be subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company. This would appear to preserve the common law rule requiring directors to consider or

act in the interests of creditors when the company is facing insolvency (as classically set out in *West Mercia Safetywear Ltd (in liquidation) v Dodd* [1988] BCLC 250).

There is no indication as to the time when the directors should cease to act in the interests of the company (taking into account the other interests) and consider or act in the creditors' interests. Some directors may determine that they should delay making a decision to file for insolvency where to do so would, for example, impact adversely on the company's employees, the community, the environment or any of the other interests to which they are to have regard. Perversely, this could open them up to claims for wrongful trading where the company was clearly insolvent at the time. Accordingly, how the new statutory statement will work in practice when a company is in financial difficulties will be a key area of interest. It is to be expected that interest groups, including the shareholders, might seek to use the new provisions (rightly or wrongly) to apply pressure in times of trouble, resulting in even more difficult times for directors.

We expect that the proposed statutory statement of directors' general duties will, at least initially, cause some confusion and concern for directors when a company is nearing insolvency. In particular, directors are likely to require substantial advice as to whom their duties are owed in such circumstances and how they should discharge them. There might also be an impact on director and officer liability insurance if it leads to increased litigation. For U.S. directors of U.K. companies, there will be much food for thought in all of this.

Dissolution and Restoration of Companies: Procedures Simplified

Where a company has been dissolved, the liquidator, or any other person appearing to be interested, currently has two years to apply to court for a declaration that the dissolution was void (section 651, Companies Act 1985). Outside of insolvency proceedings, the English registrar of companies has power to strike-off a defunct company from the register of companies. In such circumstances, the company, the members or creditors currently have 20 years to apply to court for restoration (section 653(3), Companies Act 1985).

Under the new law, the distinction between sections 651 and 653 will no longer exist. Instead, an application may be made to court for restoration to the register where a company has been struck-off

voluntarily, for being defunct or where it has been dissolved under the Insolvency Act 1986. The Act lists possible applicants, which helpfully include the Secretary of State. The Secretary of State may wish to apply, for example, in order that director disqualification proceedings can be instigated and the company's affairs investigated. Any application under the new provisions may only be made, however, within *six years* from the date of dissolution (other than where proceedings are brought for damages for personal-injury claims where no time limit exists).

One of the reasons a members' voluntary liquidation is currently seen as more attractive than simply allowing a company to become defunct and struck-off by the registrar is that a 'hidden' creditor would have only two years to apply to court to declare the dissolution void, rather than 20 years if the company had become defunct and struck-off. This distinction will, under the Act, no longer exist. In some circumstances, therefore, in order to save costs, it may be more appropriate for companies to be allowed to become defunct rather than be put into members' voluntary liquidation.

In addition, liquidators will need to be careful when asking for indemnities prior to these provisions coming into force. The

term of liquidators' indemnities is usually restricted to two years (the current period during which an objection to dissolution may be made). However, once the Act comes into force, a creditor will have six years from dissolution to apply for restoration. Accordingly, a liquidator's indemnity will need to reflect this. Moreover, until it is clear what the transitional provisions will be, liquidators may need to seek even longer indemnities to cover the period from now until the Act comes into force and then a further six years.

The changes introduced by the Act are likely to be of most relevance to the U.S. reader in group reorganisations where the tool of a members' voluntary liquidation is frequently used to remove unwanted companies from a group structure or facilitate intra-group asset transfers, for example.

Arrangements and Reconstructions

As part of the exercise of restating the Companies Act 1985, the Act restates the regime currently provided by section 425 of the Companies Act 1985 (schemes of arrangement). An attempt has been made to

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ensure that under the new law, the drafting is more in line with plain English principles. There is no intention of making substantive changes.

There is an unfortunate error in the drafting of the Act, since an administrator is permitted to make an application for a scheme meeting only if “*an administration order is in force*” in relation to the company. There are no indications that this is anything other than an oversight, since there can be no logical or policy reason as to why an administrator appointed out-of-court should also not be able to apply for the sanctioning of a scheme of arrangement. Nevertheless, to avoid confusion, this drafting error ought to be corrected.

Reductions of Capital and Financial Assistance

The procedure for a private company to reduce its share capital is made less onerous under the new law. Instead of a court application, a company may pass a special resolution supported by a directors’ solvency

statement. Capital reductions, often seen in combination with schemes of arrangement, may be relevant where a company is seeking to eliminate accumulated losses on its accounts, returning value to shareholders or distributing assets to shareholders (*i.e.*, in return for the reduction).

The restriction on private companies from giving financial assistance for the acquisition of their own shares is also removed so that the “whitewash” procedure will no longer be needed. This will clearly be relevant in distressed M&A and refinancing situations where the issue of financial assistance can increase costs and cause delays. However, it is not clear whether certain common law rules on maintenance of capital will continue to operate to make financial assistance difficult in some circumstances.

Substantial Property Transactions

The requirement for members’ approval of certain substantial property

transactions between the company and a director is, under the existing 1985 Companies Act, not required where the company is in liquidation (unless it is a members’ voluntary liquidation). The Act extends this exception to where a company is in administration. This recognises that administrations may be used to achieve better realisations than a winding-up or to realise property for distribution purposes.

Comment

Given that the current intention is for most provisions of the Act to come into force by October 2008, U.K. and non-U.K. companies and advisers must be careful not to lose interest in the changes and to ensure that they remain fully apprised of the situation. Potential insolvency officeholders and creditors also need to keep an eye out on the timing of implementation of the various provisions of the Act and begin to consider how the changes will affect them. ■