

The Companies Act 2006:

Transactions with directors and directors' service contracts

The Companies Act 2006 received Royal Assent on 8 November 2006 and is being implemented in phases, with the whole Act coming into force by October 2009. This briefing outlines the key changes which the 2006 Act will introduce in relation to loans to directors, substantial property transactions with directors, payments for loss of office, and directors' service contracts. These changes all came into force on 1 October 2007. As was the case under the Companies Act 1985, these provisions also apply to shadow directors.

We have prepared briefings on other aspects of the 2006 Act, including directors' duties and liabilities and more general summaries of the key changes for private companies, private equity firms, companies listed on AIM and Official List companies, all of which are available from our website at <http://www.traverssmith.com>.

Loans to directors

Requirement for shareholder approval

The 2006 Act has removed the general prohibition on a company making loans to directors, replacing this with a requirement for companies to obtain prior shareholder approval for loans. The requirement covers loans to a company's directors or to the directors of its holding company or to any "connected persons" of such directors. Shareholder approval must be given by ordinary resolution passed at a general meeting or, for private companies, in writing. Public companies or companies associated with a public company also have to obtain shareholder approval in relation to "quasi-loans" made to a director (or his connected persons) and "credit transactions" entered into for the benefit of a director (or his connected persons)¹. For a loan to a director of the holding company, the transaction must be approved by both the members of the company making the loan and the members of its holding company.

As under the 1985 Act, the restrictions extend to the giving of a guarantee or security in connection with a loan, quasi-loan or credit transaction made to a director, and also certain other related transactions.

Before the proposal is put to shareholders, the company must provide them with a written memorandum explaining the nature and purpose of the loan.

Exceptions

Under the 2006 Act, the exceptions to the general requirement to obtain shareholder approval cover:

- loans by non UK-registered companies or companies which are wholly-owned subsidiaries;
- expenditure in connection with company business (this has been retained from the 1985 Act; however, the maximum threshold will be increased to £50,000);

¹ A "quasi-loan" is a transaction whereby a creditor agrees to pay (or otherwise pays) a sum for the borrower or agrees to reimburse (or otherwise reimburses) expenditure incurred by the borrower, and the borrower subsequently reimburses the creditor. A "credit transaction" is a transaction under which the creditor supplies goods or sells land under a hire-purchase or conditional sale agreement; leases or hires any land or goods in return for periodical payments, or otherwise disposes of land or supplies goods or services on the understanding that payment is to be deferred.

- advances to directors to help them fund their defence against proceedings brought against them for negligence or breach of duty. This exception now covers regulatory investigations and proceedings (e.g. by the FSA) as well as civil or criminal proceedings, and also enables a company to make an advance to a holding company director as well as the company's own directors;
- minor and business transactions - the current exception for loans or quasi-loans of small amounts has been extended from £5,000 to £10,000 and, for minor credit transactions, from £10,000 to £15,000. As under the 1985 Act, there also is an exception for credit transactions entered into by a company in the ordinary course of the company's business and on arm's length terms;
- intra-group transactions - this exception is substantially the same as under the 1985 Act; and
- loans by banks and other "money-lending" companies - the maximum limit under the 1985 Act on amounts permitted under this section is removed. This exception also covers loans made to facilitate the purchase of a sole or main residence by directors and employees of "money-lending companies".

Consequences of non-compliance

The criminal penalties for non-compliance with the relevant sections is removed, but the transactions are voidable and any director in receipt or who authorised the loan has to account to the company for any gain he has made or indemnify the company for any loss or damage arising from the transaction.

Payments for loss of office

The basic prohibition on a company making a payment for loss of office to a director of the company, without shareholder approval, has been retained in the 2006 Act. The 2006 Act also now provides that a company may not make a payment for loss of office to a director of its holding company unless the payment is approved by the members of each company. Although the section also provides that approval is not needed by the members of a non UK-registered company or a wholly-owned subsidiary, careful consideration must be given to payments by any group companies and whether or not approval is needed. The 2006 Act contains some useful clarification about previous uncertainties, such as whether payments to past directors, non-cash payments or payments which have already been contractually agreed are caught by the prohibition (see below).

The 2006 Act includes a new definition of "payment for loss of office", which includes payments made to both directors and past directors. As well covering compensation for loss of office as a director, it also extends to compensation for loss of any other office or employment related to the management of the affairs of the company or its subsidiaries, where this loss occurs either while the person concerned is a director or in connection with his ceasing to be a director (in other words, this covers compensation for loss of employment rather than purely the loss of a directorship itself). The definition also covers payments made to a person in connection with, or in consideration for, his retirement (again, this covers retirement from office as a director and from any other office or employment in connection with the management of company affairs).

"Compensation" and "consideration" cover both cash and non-cash benefits. The provisions extend to payments to "connected persons" of a director, and also apply to payments made to any person at the direction of, or for the benefit of, a director.

Shadow directors are treated as directors for the purposes of these sections - although any reference to loss of office as a director does not apply to loss of a person's status as a shadow director. Given the breadth of the payment for loss of office definition, it is possible to see how a shadow director might easily be caught if he received a payment from the company.

Transfer of an undertaking and share transfers

The previous requirements for shareholder approval for payments to directors for loss of office in connection with the transfer of an undertaking or a share transfer (including transactions involving subsidiaries) have been retained. A memorandum containing particulars of the proposed payment must be prepared and circulated or made available to members before they are asked to approve the transaction, as with the approval of a loan to a director.

Exceptions from the prohibition

Approval is not required for a payment made in good faith:

- in discharge of an "existing legal obligation", such as payments in lieu of notice or payments under a change of control clause in the director's service contract;
- by way of damages for breach of such an obligation;
- by way of settlement or compromise of any claim arising in connection with the termination of a person's office or employment (which would include compensation for an unfair dismissal or discrimination claim); or
- by way of pension in respect of past services.

There is also a new exception for small payments, i.e. where the amount or value of the payment, together with the amount or value of any other relevant payments does not exceed £200.

Failure to obtain approval

If the basic prohibition on a payment by a company is breached, then the recipient will hold the payment on trust for the company making the payment. In addition, those directors who authorised the payment are personally liable to the company for any loss resulting from it.

If approval is not obtained for a payment made in connection with the transfer of an undertaking, then the payment will be held on trust for the company whose undertaking has been transferred. If approval is not obtained in connection with a share transfer, then the payment will be held on trust for those who sell their shares as a result of the offer.

Substantial property transactions

The 2006 Act retains the requirement for members to approve the direct or indirect acquisition from the company of a substantial non-cash asset by a director of the company or its holding company (or a person connected with the director) or, alternatively, the acquisition of the asset by the company from the director (or his connected person). It is now possible for an arrangement to be entered into before approval has been obtained, conditionally on approval being given.

The threshold for transactions requiring approval has been raised from £2,000 to £5,000. A "substantial asset" is therefore either one which exceeds 10% of the company's net asset value and is more than £5,000, or one which exceeds £100,000.

Helpfully, it is now clear that shareholder approval is not needed for the transfer to or from a director of a non-cash asset pursuant to his service contract or as payment for loss of office.

There are various other exceptions, including for transactions if the company is being wound up or is in administration. Where a company enters into an arrangement which contravenes the substantial property transaction rules, the contract is voidable and any director who entered into the transaction or who authorised it may have to account to the company for any gain he has made or indemnify the company for any loss or damage resulting from the transaction.

Definition of connected persons

Most of the requirements for shareholder approval under the 2006 Act for transactions with directors also extend to transactions involving their "connected persons". The 2006 Act makes the following changes to the existing definition of "connected persons":

- The age limit on director's children or step-children included in the definition is removed.
- The definition extends to:
 - persons with whom the director lives "as partner in an enduring family relationship" (unless the person is the director's grandparent or grandchild, sister, brother, aunt or uncle, nephew or niece);
 - children or step-children of the director's unmarried partner (see above) who live with the director and are under 18 years old; and
 - director's parents.

Service contracts

Shareholder approval

The requirement to obtain shareholder approval for directors' service contracts is extended to apply to contracts whose term is, or may be, longer than 2 years (rather than 5 years as under the 1985 Act). In an important change, "service contract" for these purposes includes consultancy as well as employment arrangements involving directors, and will also include non-executive directors' letters of appointment. Approval is not required by the members of a company which is either a non UK-registered company or a wholly-owned subsidiary. The 2006 Act provides greater detail on the procedure for obtaining approval, which includes a requirement for a memorandum setting out the proposed contract to be available before and at the relevant shareholder meeting.

Disclosure

The 2006 Act retains the obligation on companies to keep available for inspection free of charge a copy of every director's service contract (defined as above) or, if the contract is not in writing, a written memorandum setting out its terms. The obligation applies regardless of the duration of the contract and whether it will be terminated by the company without the payment of compensation in the next 12 months (this is an important change from the 1985 Act). Under the 2006 Act, copies of service contracts must be kept at the company's registered office or elsewhere in accordance with regulations yet to be published by the Government.

In addition to the right to inspect service contracts at the company's registered office, the 2006 Act gives shareholders a right to request a copy of a director's service contract (or memorandum of its terms) upon payment of a fee. A copy must be provided within 7 days of the company receiving the request.

Interaction with statutory duties of directors

As mentioned above, we have prepared separate briefings on the new statutory duties of directors under the 2006 Act. The 2006 Act provides that compliance with the general duties does not remove the need for approval under the relevant provisions dealing with transactions which require members' approval.

If you require further information on any of the matters outlined in this note, please speak to your usual contact at the firm.

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