The Association of Corporate Treasurers

Briefing note:

The Impact of the UK's Companies Act 2006 on Loan Documentation

TREASURY, RISK
AND FINANCE
PROFESSIONALS
ACT

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THE IMPACT OF THE UK's COMPANIES ACT 2006 ON LOAN DOCUMENTATION: A BRIEFING NOTE FOR TREASURERS

The UK's Companies Act 2006 ("**CA 06**") – thought to be the longest ever statute, with over 1300 clauses - comes into force in phases over the next 2 years, with some provisions already in force.

Many of its provisions codify or re-state the existing law. Although minimal amendment will be required to loan documentation, there are some points for treasurers to look out for in relation to loan documentation. The CA06 has wider implications for treasurers, particularly if they act as directors, but that is not the focus of this briefing.

1. SUMMARY

The Companies Act 2006 codifies directors' duties and brings out the concept of enlightened shareholder value. This means there is likely to be a greater focus on the content of board minutes which are normally required as a condition precedent. Generally speaking, in the context of a plain vanilla corporate loan, it will be inadvisable and unnecessary to extend board minutes to itemise consideration of the enlightened shareholder value factors.

Directors may be at greater risk of liability for breach of duty as a result of the new derivative claims regime, which cam into force from 1 October 2007. A derivative claim is a claim brought by a shareholder on behalf of the company against a director, for example for breach of fiduciary duty or negligence.

Against this background, it is thought that some Lenders may be considering extending the existing provisions in loan documentation dealing with litigation to cover derivative claims. For example, the LMA Agreement for Investment Grade Borrowers includes a representation as to "no litigation" at Clause 19.13. Borrowers will want to oppose the extension of this representation on the grounds that a derivative claim is one made on behalf of the company against a defaulting director: the Lenders' concern in this representation is properly with proceedings against the company. Lenders may argue that a claim against a director should be of concern to them because it could indicate the existence of a problem which could entail a material adverse change in the Borrower's position in some way. The counter to this is that if so it should be dealt with through other protective provisions, such as financial covenants or a Material Adverse Change clause.

There are new provisions in the Companies Act 2006 and the Disclosure and Transparency Rules which are designed to facilitate electronic communication. While they do not directly affect credit documentation, they may give Lenders and Borrowers scope to discuss increased use of e-communication. The LMA (Loan Market Association) documentation – in line with market practice - does not currently permit electronic communication between Borrower and Agent, however lenders may now be prepared to discuss provision for notices, for example on drawdown, by email.

2. CHANGES IN FORCE AT 1 OCTOBER 2007

2.1 Directors' duties

The codification of directors' duties will require attention from directors and those briefing them.

The CA 06 codifies directors' duties with a view to reflecting the common law position in statute, but with some significant changes. The following are the codified duties (but note that these do not cover all of the duties a director may owe to a company, for example the duty to consider the interests of creditors in times of threatened insolvency):

- to act within powers – a director must act in accordance with the company's constitution and only exercise his powers for the purposes for which they were conferred;

- to promote the success of the company – a director must act in the 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, having regard to certain matters (see below);

- to exercise independent judgement;

- to use reasonable care, skill and diligence – note that a director is judged in relation to both the knowledge, skill and experience expected of someone in his position and the knowledge, skill and experience he actually has;

- to avoid conflicts of interest – a director must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company;

- not to accept benefits from third parties; and

- to declare interests in proposed transactions and arrangements.

The first four of these are in force from 1 October 2007. The implementation date for the last three is expected to be announced in December 2007.

These duties apply equally to the directors of all types of company.

2.2 "Enlightened Shareholder Value"

In fulfilling his duty to promote the success of the company, the director must have regard (amongst other things) to the following:

- the long term consequences of any decision;
- the interests of the company's employees;
- the need to foster 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.

A director owes his duties solely to the company, except in limited cases (e.g. insolvency as noted above). The directors are not obliged to prioritise any one factor over any other, so that they are not required for example to promote the interests of the environment or third parties over the interests of the company and its success. However, they must "have regard to" the above factors when forming decisions. The Government has maintained consistently that consideration of the listed factors is not to be merely a formality. As was said in Parliament, "The words "have regard to" mean "think about"; they are absolutely not about just ticking boxes . . . In other words, "have regard to" means "give proper consideration to . . ." (Ministerial Statement June 2007: http://uarwebsrv1/onenet/Duties_of_Company_Directors_Ministerial_Statement.pdf).

2.3 Board minutes

The conditions precedent to a loan agreement invariably require sight of the board minutes authorising the transaction. In the light of the codification of directors' duties under the CA 06, there is likely to be a greater focus on the content of board minutes.

Generally speaking, in the context of a plain vanilla corporate loan, it will be inadvisable to extend board minutes to itemise consideration of the enlightened shareholder value factors; but the circumstances of each individual transaction will have to indicate the appropriate approach.

For more detailed guidance on this topic, please see the Annex to this note.

2.4 New derivative claims regime

Directors may be at greater risk of liability for breach of duty as a result of the new derivative claims regime, which is in force from 1 October 2007. A derivative claim is a claim brought by a shareholder on behalf of the company against a director, for example for breach of fiduciary duty or negligence. Until now, the law governing these claims has been complex, and so in practice they have been rare.

Under the new procedure, the basis on which a derivative claim may be brought is much wider. Concerns about the increased scope of potential claims arising from the new regime have however been allayed to a significant extent by the strict procedural tests that a potential claimant has to satisfy before his claim can be heard.

It is thought that, at least in the private company context, derivative claims will remain highly unusual. Since the remedy for a derivative action is in favour of the company, it is expected that shareholders will continue to prefer an action for unfair prejudice, which provides a buy out remedy; these provisions are largely re-stated in CA 06. However, there is a risk that, in the public company sphere, derivative actions may be used as a tactical measure. In practice, it remains to be seen how the courts will interpret the new provisions. Even if in the longer term the attitude of the courts prevents an increased number of claims, there may be a short term increase in litigation after the new provisions come into force, while shareholders test the courts' approach.

Against this background, it is thought that some Lenders may be considering extending the existing provisions in loan documentation dealing with litigation to cover derivative claims. For example, the LMA Agreement for Investment Grade Borrowers includes a representation as to "no litigation" at Clause 19.13. Currently this covers claims against members of the Borrower's group, on the basis that they could lead to substantial liabilities for the company, but not a derivative claim, as a claim made on behalf of the company. The concern is that a derivative claim could also have a material adverse effect on the Borrower, for example through harmful press attention, and ultimately a negative impact on its financial condition.

Borrowers will want to oppose the extension of this representation on the grounds that a derivative claim is one made on behalf of the company against a defaulting director: the Lenders' concern in this representation is properly with proceedings against the company. A claim against the company could have an impact on its financial condition; a successful derivative claim could result in compensation or a recovery of moneys for the Borrower.

Lenders may argue that a claim against a director should be of concern to them because it could indicate the existence of a problem which could entail a material adverse change in the Borrower's position in some way. Borrowers however can counter this by pointing to the many other protective provisions in the contract. Borrowers will want to argue that the Lenders should not be entitled to accelerate unless there were a breach of one of the other protective provisions, such as financial covenants or a Material Adverse Change (MAC) clause.

If necessary however a possible compromise could be to agree to provide information about a derivative claim which the court permits to proceed, as this process is intended to eliminate frivolous and vexatious claims, though it could take some months.

Alternatively, inclusion of derivative claims in a representation may be acceptable if subject to a materiality qualification focussing on the financial condition of the company. In this context it would be necessary to consider the definition of Material Adverse Effect.

2.5 Security over shares

With the aim of improving the position of indirect investors in a company, the Government has included provisions in the CA 06 that will allow shareholders to nominate a third party to enjoy their information and other rights. Where a Borrower grants security over shares, Lenders will need to insert protective provisions addressing the rights of indirect investors.

2.6 E-communication

New provisions of the CA 06 and the Disclosure and Transparency Rules are designed to facilitate electronic communication. While they do not directly affect credit documentation, they may give Lenders and Borrowers scope to discuss increased use of e-communication.

For example, the CA 06 provides that shareholders and debenture holders may in certain circumstances be deemed to consent to the provision of information to them via a website. The LMA documentation currently permits financial information to be provided on a website rather than in paper form only to those Lenders who consent (Clause 20.6 of the LMA Agreement for Investment Grade Borrowers). Borrowers may wish to consider introducing the deemed consent concept into arrangements with Lenders.

The LMA documentation – in line with market practice - does not currently permit electronic communication between Borrower and Agent (Clause 31.5 of the LMA Agreement for Investment Grade Borrowers). Lenders may however now be prepared to discuss provision for notices, for example on drawdown, by email.

3. CHANGES FROM OCTOBER 2009

3.1 Financial assistance

The prohibition on financial assistance will cease to apply in relation to private companies as from 1 October 2009, when the CA 06 will effectively re-state the existing regime for public companies only.

Target public companies and their public or private company subsidiaries will still be prohibited from providing financial assistance for the acquisition of shares in the target public company.

A public company subsidiary of a private company will also still be prohibited from providing financial assistance in connection with the acquisition of shares in its private holding company.

Breach of the financial assistance prohibition will remain a criminal offence; the penalty has been increased to imprisonment for up to 12 months.

The abolition of the "whitewash procedure" will shorten transaction timetables, and transaction costs should also be reduced. (The whitewash procedure allowed for an authorisation by means of a special resolution approval, a director's solvency declaration and a report by the auditors.)

However, directors must ensure that the proposed transaction will promote the success of the company for the benefit of its shareholders (or, using the old formulation, is in the best interests of the company), and that it does not constitute an unlawful distribution. The giving of financial assistance, such as a guarantee or indemnity or the grant of security, will still be subject to the rules as to undervalue and other insolvency considerations as at present.

3.2 Company charges

The provisions of the Companies Act 1985 on the registration of company charges are largely restated in the CA 06. This will result in some minor changes to documentation for secured financing transactions in terms of references to the relevant sections. Registration of charges will, for example, no longer be on a Form 395 but on a Form 860.

Further reform in this area is however expected:

- The CA 06 provides for regulations to be made which would end the so called "Slavenburg" practice of protective security filings by certain overseas companies.
- The CA 06 also provides for regulations to be made avoiding the current duplicative registration requirements in relation to land, ships and aircraft.

The secondary legislation is awaited.

ANNEX

Companies Act 2006 – Directors' Duties

Board procedures

1. Board procedures – in general

All companies should ensure that all board members are aware of their duties under the CA 06 and that company policies should reflect the listed factors. The GC100 (in their paper published in February 2007 (http://www.practicallaw.com/jsp/binaryContent.jsp?item=:29689743) recommend that this can be done in all or some of the following ways:

- as a transitional move, boards should be given a thorough briefing on the new duties introduced by the CA 06;
- on appointment, all new directors should be briefed upon their duties under CA 06;
- the terms of appointment and description of the role of any director should specifically refer to his duties;
- the terms of reference of any board or committee may also refer to those duties; and
- companies should review their existing policies in areas such as human resources, ethics, compliance and corporate responsibility against the background of the new duties.

In addition to the above, it is suggested that:

(i) the company should ensure that management and those responsible for preparing board papers are also given a thorough briefing on the new duties of directors; and

(ii) when the board reviews the strategy of the company, care is taken to ensure that the relevant factors are considered and taken into account in deciding the strategy to be adopted.

Since not all board decisions will be formally minuted, and many decisions affecting a company will be taken by a sole director in less formal circumstances than a board meeting, it will be advisable that all directors of all companies should be briefed on the importance, when making decisions, of thinking about the listed factors as part of the consideration as to whether the transaction will promote the success of the company.

In addition, when preparing board papers for directors to review, management should be encouraged to highlight the importance of considering each of the factors (where relevant) and to include relevant commentary on them. It may also be helpful to adopt a policy of circulating a short summary of the directors' duties with board papers.

2. Board procedures – authorisation for a loan agreement

Even if directors are sometimes able to discount some of the "enlightened shareholder value" factors as being irrelevant to the transaction proposed, they will need to consider them (together with any other relevant factors) when deciding whether a proposed credit facility will promote the success of the company for the benefit of its members as a whole.

The issue of consideration of the listed factors by the directors leads to the separate issue of the extent to which it is prudent to record that consideration in board minutes. Many company secretaries and corporate legal counsel are concerned that the new legislation will give rise to the unnecessary reworking and extension of board minutes as a purely defensive reaction and so hamper the decision-making process. The GC100 paper mentioned above expresses the view that directors have not previously been, and should not be, obliged to evidence their thought processes, whether with regard to the stated factors or any other matter: "Apart from the unnecessary process and paperwork this would introduce in to the boardroom, it would inevitably expose directors to a greater and unacceptable risk of litigation, especially in light of the new derivative action also being brought in by the CA 06."

Although the Government has emphasised that companies must not pay mere lip service to the requirements of the CA 06, board minutes which state, for example, that the directors have had regard to the listed factors, present the greatest opportunity for attack; indeed, the greater the detail given, the greater the opportunity for challenge. Given that the requirement is that a director must act in the way he (subjectively) considers, in good faith, would be most likely to promote the success of the company, there is an argument for recording nothing specific. It will then be open to the directors to meet a challenge with the response that the factor at issue had indeed been considered by them.

The GC100's view is that best practice should be for the management team preparing a background paper for a board discussion of a proposal to ensure that each of the listed factors is properly considered while the paper is being prepared. If necessary the factors can be considered in the paper or any presentation made.

With regard to the minutes, the GC100 suggestion is that "where the nature of the decision being taken by directors is such that it is supported by a formal process, that process need only specifically record consideration of those duties where the particular circumstances make it particularly necessary or relevant. The default position should be not to include those references".

Before agreeing to alter the contents of their minutes from their usual form, directors should consider the possible inferences that could be drawn where minutes approving a loan facility record consideration by the directors of their duties, in contrast to minutes recording other decisions which do not do so: it might allegedly be implied that the directors had not properly considered their duties in relation to other decisions. Another point to consider is that, in some circumstances, the directors may wish to discuss some or all of the factors at length. It might then be appropriate to record that discussion. There would however be an obvious risk in recording discussion of some but not all of the factors.

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The Association of Corporate Treasurers

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This briefing note was prepared by Slaughter & May.

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