



SCVO WORKSHOP

Companies Act 2006 – Charitable Issues

19 June 2007



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Introduction

The Companies Act 2006 (“**the Act**”) received Royal Assent on 8 November 2006. The Act repeals and restates the greater part of existing companies legislation comprising 1,300 sections and 16 schedules with much secondary legislation to follow.

Many of the reforms enact proposals suggested by the Company Law Review. Others implement European Directive requirements and some are a response to case law developments.

It is expected that the Act will be fully in force by October 2008 with some provisions brought into force earlier. Specific information regarding implementation dates should be sought in relation to particular provisions. There are three implementation dates scheduled at the moment those being 1 October 2007, 1 April 2008 and 1 October 2008.

Most charities that envisage entering into contracts and dealing with external organisations choose to organise themselves as companies limited by guarantee. The provisions of the Act are directly applicable to those charities. Additionally, for those entities which are not subject to company law, the provisions of the Act can give some guidance in relation to systems of management and control and good governance particularly in the provisions applicable to directors and the duties incumbent upon them.

Given its size, it is not practicable to provide a short and comprehensive account of the relevant provisions of the entire Act. This talk will look at principal changes in key areas including:-

1. Constitutional issues
2. Directors
3. Company secretaries
4. Shareholders
5. Administration issues
6. Accounts and Auditors

1. Constitutional Issues



applicable to charities (for instance, to comply with the charity test) and some community interest companies may also choose to do so.

These provisions mean that key information relating to the internal allocation of powers between directors and members of a company will now appear in one place – the articles of association.

At the moment, companies can entrench elements of their constitution in their memorandum of association. This in particular applies in relation to charitable companies and companies limited by guarantee which often have restrictions on the entities to which assets may be transferred on winding up contained in their memorandum. Under existing law these provisions cannot be altered.

Under the new regime it will be possible for companies to entrench elements of their constitution in their articles and where the memorandum of an existing company contains a provision for entrenchment this will be treated as a provision in the company's articles. A provision for entrenchment may only be made in the company's articles on formation or by an amendment agreed to by all members (i.e. not simply by relying on the deeming provision).

A company's articles will be able to provide that entrenched provisions can only be amended or repealed if certain conditions are met or procedures complied with that are more restrictive than is applicable in the case of a special resolution (which requires the support of 75% of the members).

For example, the articles could provide that a provision restricting the entities to which assets may be transferred on a winding up may only be altered with the consent of 90% or even 100% of the members.

A company will need to give notice to the Registrar of any provisions for entrenchment contained in its articles. If an amendment is made to remove such a provision a copy of the resolution together with a statement of compliance certifying that the alteration has been made in accordance with the company's articles must be delivered to the Registrar. If any provision for entrenchment is removed, further notice of that fact must also be given.

Transitional provisions dealing with the position of existing companies are awaited. These are likely to seek to maintain the status quo (and, accordingly, the expectations of investors and other interested parties).



2. Directors

A new statutory statement of directors' duties is introduced by the Act. These duties are expressed as being based on common law rules and equitable principles. The statutory statement is designed to make this area of the law more accessible to the average director.

The Charity Trustees and Investments (Scotland) Act 1995 ("**the 1995 Act**") defines a "charity trustee" in section 106 as follows:-

"The persons have the general control and management of the administration of a charity".

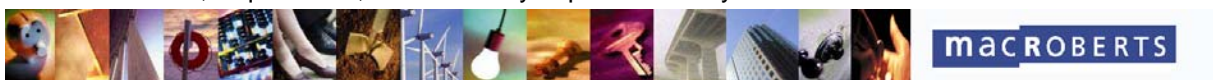
Charity trustees in the context of a company limited by guarantee are likely to equate to the directors. The legal duties and responsibilities of the management committee of a charity will, in part, depend on the type of structure implemented.

Charity trustees are already under a regime of common law duties and statutory duties imposed by the 1995 Act. Section 66 of the Act sets out the general duties of a charity trustee as follows:-

- "(1) A charity trustee must, in exercising functions in that capacity, act in the interests of the charity and must, in particular:-
- (a) seek, in good faith, to ensure that the charity acts in a manner which is consistent with its purposes;
 - (b) act with the care and diligence that it is reasonable to expect of a person who is managing the affairs of another person; and
 - (c) in circumstances capable of giving rise to a conflict of interest between the charity and any person responsible for the appointment of a charity trustee –
 - (i) put the interests of the charity before those of the other person, or
 - (ii) where another duty prevents the charity trustee from doing so, disclose the conflicting interest to the charity and refrain from participating in any deliberation or decision of the other charity trustees with respect to the matter in question"

The section goes on to amplify the particular duties of a trustee.

Sub-section 2 provides that charity trustees must ensure that the charity complies with any direction, requirement, notice or duty imposed on it by virtue of the Act.



The duties set out in sub-sections (1) and (2) are without prejudice to any other duty imposed by enactment or otherwise on a charity trustee in relation to the exercise of functions in that capacity. Accordingly, all of the common law duties incumbent on charity trustees and all duties and obligations contained in other statutory enactments also apply.

Any breach of the duties set out in sub-sections (1) and (2) are to be treated as misconduct in the administration of the charity.

All charity trustees must take such steps as are reasonably practicable for the purpose of ensuring that any breach of duty is corrected by the trustee concerned and not repeated and that any trustee who has been in serious or persistent breach of either or both of those duties is removed as a trustee.

Where it appears to OSCR that as a result of enquiries there has been misconduct in administration of a charity (for example arising as a result of a breach of the duties set out in section 66) OSCR may, by notice, suspend any person concerned in the management or control of the charity or body and can protect the charity's property by directing any relevant financial institution or other person holding property on behalf of the charity not to part with that property without OSCR's consent.

A person who, without reasonable excuse, contravenes a suspension order is guilty of an offence and liable on summary conviction to a fine not exceeding level 5 on the standard scale or imprisonment for a period not exceeding six months or both.

Anyone convicted of an offence under the Act is disqualified from being a charity trustee. A person who acts as a charity trustee whilst disqualified is, in terms of section 70 of the Act, guilty of an offence and liable on summary conviction to imprisonment for a period not exceeding six months or a fine not exceeding level five on the standard scale or, both or, if convicted on indictment, to imprisonment for a period not exceeding two years or a fine or both.

It is obviously worthwhile for trustees to take steps to comply with their common law and statutory obligations. Having a suitable scheme of governance in place can help charity trustees to do so. It is fundamental that charity trustees are in control and have clear policies, procedures and reporting mechanisms that actually work.

Those charity trustees who are also directors of companies limited by guarantee will, in addition, be subject to the new statutory statement of directors' duties. Those entities which are not incorporated may wish to consider the duties to which directors are subject as representing good corporate governance and incorporate them into any policies and procedures they might have.



What exactly are the duties?

Anyone ceasing to be a director continues to be subject to a duty to avoid conflict of interest as regards exploitation of property, information or opportunities of which he became aware when he was a director and to the duty not to accept benefits from third parties in relation to things done or not done by him before he ceased to be a director.

Shadow directors (persons in accordance with those directions or instructions the board is accustomed to act) are also covered by the general duties to the extent that they are currently subject to fiduciary duties. This in essence means that where a shadow director deals with the assets of a company he may find himself bound by the statutory duties.

The general duties are:-

- (1) A duty to act in accordance with the company's constitution and exercise powers for the purposes for which they are conferred.
- (2) A duty to act in a way in which the 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.

In fulfilling this duty, directors must have regard to 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 maintaining a reputation for high standards of business conduct and the need to act fairly as between members of the company. (This duty is subject to any provisions of insolvency law requiring directors to consider or act in the interests of the creditors of the company in certain circumstances).

- (3) A duty to exercise independent judgement.

This is not infringed by a director acting in accordance with any agreement entered into by the company which restricts the future exercise of discretion by its directors or in a way authorised by with the company's constitution.

- (4) A duty to exercise reasonable care, skill and diligence.

The care, skill and diligence to be exercised is that of a reasonably diligent person having both the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by that director and his actual general knowledge, skill and experience.



The test is accordingly a mixed subjective/objective test. This means that, for example, different directors may have different levels of care, skill and diligence expected of them. A director with financial qualifications acting as finance director will owe a different level of care, skill and diligence to the company than a director with a marketing degree acting as a sales director. The courts in considering such a duty will consider the skill set of the particular director and the functions carried out by him.

- (5) A duty to avoid any 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.

This applies in particular to the exploitation of any property, information or opportunity. It is immaterial whether the company was in a position to take advantage of the property, information or opportunity itself.

This duty is not infringed where the situation could not reasonably be regarded as likely to give rise to a conflict or if the matter has been authorised by the directors. The directors can give authority (in relation to private companies) where nothing in the company's constitution invalidates such authorisation.

Any quorum or vote has to be calculated under exclusion of the director in question.

- (6) A duty not to accept benefits from a third party conferred by reason of his being a director or his doing or not doing anything as a director.
- (7) A duty to declare any interest in a proposed transaction or arrangement.

Such a declaration can, but does not need to, be made at a meeting of the directors or by giving notice to the directors and has to be made before the company enters into the transaction or arrangement.

Consequences of breach can include damages or compensation where the company has suffered loss, restoration of the company's property, an account of any profits made and rescission of a contract where the director fails to disclose an interest.

More than one of these duties can apply in any given case.

Further provisions require directors to declare any interest that they have in an existing transaction or arrangement entered into by the company.

Appointment



The rules relating to appointment of directors have also changed. Private companies must have at least one director (public companies must have at least two) and at least one director in each case must be a natural person. Accordingly one company cannot be the sole director of another company. Directors will be appointed in accordance with the articles of association of the company concerned.

Age

A new provision has been introduced providing a minimum age of 16 for a natural person to be a director. Any appointment made in contravention of that clause is void.

Ratification

Any negligence, default, breach of duty or breach of trust on the part of a director is ratifiable by members' resolution. Where ratification is possible, it must be effected by excluding the votes of the director concerned if he is a member and those of any member connected with him.

Notice of interests

Any declaration of interest in a transaction or arrangement must be made as soon as reasonably practicable using one of three methods:-

- (i) at a meeting of the directors; or
- (ii) by notice in writing; or
- (iii) by general notice.

A general notice is one given by the director to the effect that he has an interest (as a member, officer, employee or otherwise) in a particular company or firm and is to be regarded as interested in any transaction or arrangement that may after the date of the notice be made with that body corporate or firm or that he is connected with a specified person and is to be regarded as interested in any transaction or arrangements that may be made with that person. The notice must specify the nature and extent of the directors' interest.

A general notice is ineffective unless given at a board meeting or if the director takes reasonable steps to secure that it is brought up and read at the next meeting of directors after it is given.



Register of Directors

The details which a company has to keep and maintain on a register of directors has altered under the Act. The details to be contained in the Register of Directors comprise:-

- (a) a director's name and any former name;
- (b) his service address;
- (c) the county or state in which he is usually resident;
- (d) his nationality;
- (e) his business occupation; and
- (f) his date of birth.

A director can state his service address as being the company's registered office.

Companies must maintain in addition a new register of directors' residential addresses which must state the usual residential address of each director. If a director's usual residential address is the same as the service address then the register of directors' residential addresses need only contain an entry to that effect.

Any information in relation to a director's usual residential address (or information that his service address is his usual residential address) is described by the Act as "protected information". Information continues to be protected when an individual ceases to be a director of the company.

A company must not use or disclose protected information except for communicating with the director or to comply with requirement of the Companies Act or if required under court order.

The Registrar must omit protected information from material on the public register where it is contained in a document delivered in which such information is to be stated. The Register is not however obliged to check other documents to ensure the absence of protected information or to omit material registered before the Act comes into force.

The Registrar will only use or disclose protected information to communicate with the director in question and can disclose it to a public authority or credit reference agency. A court can order disclosure of protected information by the company or the Registrar if there is evidence that service at the service address is ineffective. An order for disclosure by the Registrar is to



be made only if the company does not have the director's usual residential address or if it has been dissolved. Additionally the Registrar can put a director's usual residential address on the public record if communications sent to the director requiring a response within a specific period remain unanswered or if there is evidence that service of documents at the service address is ineffective.

3. **Company Secretaries**

Public companies will still require to appoint a company secretary. Private companies can choose whether to appoint one or not.

Existing private companies can choose to retain their company secretaries. Where a secretary is appointed, a register of secretaries needs to be maintained and appropriate lodgements made with the Registrar of Companies.

4. **Members**

Anyone wishing to examine a company's register of members must provide the company with a request which explains who they are, the purpose for which they will be looking at the register and whether it will be disclosed to third parties. If a company does not wish to grant the request it can then apply to the courts for the court to review the request. The court must refuse the request if satisfied that the inspection is not for a proper purpose. It is a criminal offence to knowingly or recklessly make in a request a statement that is misleading, false or deceptive in any material particular.

These provisions are designed to protect shareholder privacy.

Derivative Actions

There are currently three principal ways in which legal action is taken against a director for breach of duty:-

- (1) if a board of directors resolves to commence proceedings;
- (2) if a liquidator or administrator decides to begin proceedings; and
- (3) via what is known as a "derivative action" – an action brought by one or more members to enforce a right vested not in the members but in the company.

A member has the right to raise proceedings in relation to a director's breach of duty to obtain a remedy for the company. The action is raised in the name of the member but the remedy is



obtained for the company and the rights which the member can enforce are those of the company.

Such a right arises where the action complained of is fraudulent or outwith the corporate capacity of the company and therefore cannot be validated by a majority of the members. This remedy is not available if the majority of the members acting in good faith have validated or may validate the act complained of.

The Act deals separately with derivative claims in relation to companies registered in England, Wales and Northern Ireland on the one hand and in Scotland on the other. The appropriate sections seek to ensure maximum consistency across the border and reflect different procedural requirements.

The Scottish provisions provide that a member can raise an action to protect the interests of the company and obtain a remedy on its behalf in relation to an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company (including former directors and shadow directors).

Derivative actions can only be raised with leave of the court. An application must specify the cause of action and summarise the facts.

The court must refuse leave to raise a derivative action if it is satisfied that a person acting in accordance with his duty to promote the success of the company would not raise or continue such a claim or (where the act or omission is yet to occur) if it has been authorised by the company or (if the act or omission has already occurred) where it was previously authorised by the company or has subsequently been ratified by the other members.

In deciding whether to give leave the court has to take into account whether the member is acting in good faith; the importance that a person acting in accordance with a duty to promote the success of the company would attach to raising it; the likelihood of ratification or authorisation; whether the company has decided not to raise an action and whether the cause of action is one in respect of which the member could raise an action in his own right rather than on behalf of the company.

The court also needs to give some regard to the views of members who have no personal interest in the matter.

Shareholder Communication

The rules and the ways in which companies may communicate with their shareholders have changed.



A document or information will be validly sent or supplied by a company if it is sent:-

- (1) in hard copy form (either handed to the intended recipient or sent or supplied by hand or by post) in a prepaid envelope (to an address specified for that purpose, to a corporate shareholders' registered office or to the address shown in the register of members);
- (2) in electronic form – shareholders must agree (generally or specifically) that information can be sent to them in that format and an e-mail address has to be specified for that purpose (where the recipient is another company, deeming provisions in the Act can apply); or
- (3) if it is made available on a website.

As far as website communication is concerned, the following points should be considered:-

- (1) Agreement will be deemed to have been given if:-
 - (i) the members of the company have resolved that the company can supply documents by making them available on a website; or
 - (ii) where the company's articles contain a provision to that effect; and
 - (iii) the shareholder concerned has been asked individually to agree to such provision and the company has not received a response within 28 days.

The company's request must state clearly the effects of not responding. There is no deemed agreement to website provision if the company's request was sent less than 12 months after a previous request in respect of the same or a similar class of documents or information.

Similar provisions deal with debenture holders.

- (2) Any document supplied via a website must be available in a form that enables the recipient to read and retain a copy of it.
- (3) The company must notify the recipient of the presence of the document on the website, the web address, the place on the website where the document can be accessed and how to access the information.
- (4) A document is taken to be sent on the date on which notification is sent out or the date on which the document first appears on the website if later.



- (5) The documents must be available on the website for any applicable period specified in the legislation or, where there is no specified period, for 28 days.
- (6) If a document is only available for a part of any relevant period, any failure is disregarded where it is wholly attributable to circumstances which it would have been unreasonable for the company to prevent or avoid.

Shareholders and debenture holders have the right to require information to be sent to them in paper copy form.

Companies with large numbers of shareholders (particularly quoted companies) may find these provisions represent a substantial cost saving and are useful for, for example, supplying annual reports and accounts.

5. Administrative Matters

Private companies will not be required to hold annual general meetings, to lay their annual reports and accounts before a general meeting or to appoint auditors at a company meeting.

The default position for decision making by private companies is based on the premise that they wish to conduct as much company business as possible by means of written members' resolutions rather than shareholder meetings. Written resolutions will no longer need to be signed by all shareholders. They will only need to be signed by the majority that would have been required to pass the equivalent resolution at a general meeting.

The percentage required for consent to holding a meeting at short notice is reduced from 95% to 90% for private companies. For public companies it remains at 95%.

Where no type of resolution is specified in the Act, an ordinary resolution will be required unless the company's articles require a higher majority or unanimity.

Private companies will be able to take decisions either by convening general meetings or by using the written resolution procedure. The notice period for general meetings is reduced to 14 days.

6. Accounts and Auditors

A charity must preserve accounts and records for six years from the end of the financial year in which they are made. The Scottish Ministers have the ability to make regulations containing more detail as to, for instance, the information to be contained in accounts and records and statements of account, the manner in which that information is to be presented and the



methods and principles to be used in their preparation. A charity must provide a copy of a statement of account to OSCR in accordance with Section 44. If it fails to do so OSCR may, after notifying the charity of its intention to do so, appoint a suitably qualified person to prepare a statement of account. That person (referred to in the legislation as an “appointed person”) is entitled on reasonable notice to enter premises at all reasonable times, to have access to and take possession of any documents relating to the financial affairs of the charity and to require any charity trustee, agent or employee of the charity to give such assistance, information or explanation as they may reasonably require.

The charity trustees are personally liable jointly and severally for any costs incurred by OSCR in appointing such a person and the expenses of that person in performing his functions.

The appointed person must send OSCR a statement of account, submit a report on the affairs and accounts and records of the charity and send a copy of the statement of account and report to each person appearing to be a charity trustee of the charity concerned.

Anyone failing without reasonable excuse to comply with any requirement of the appointed person is guilty of an offence.

The Charities Accounts (Scotland) Regulations 2006 apply to financial years starting on or after 1 April 2006. OSCR posted a guide to the 2006 regulations to all active charities in Scotland. It is also available on line on OSCR’s website.

Accounting periods starting before 1 April 2006

Charities which are not companies must continue to maintain accounts and records and prepare accounts in accordance with the Law Reform (Miscellaneous Provisions) (Scotland) Act 1990 and the Charity Accounts (Scotland) Regulations 1992.

Charitable companies with accounting periods starting before 1 April 2006 must prepare accounts that comply with the 1985 Companies Act.

Once charities move into financial years starting on or after 1 April 2006 they must comply with the 2006 Regulations.

The 2006 Regulations

Charity accounts must be prepared following the 2006 Regulations in one of two ways:-

1. Receipt and Payment Accounts – a simple form of accounting consisting of a summary of all monies received and paid via the bank and in cash during a financial year together with a statement of balances.



2. Accrual accounts – accounts are prepared allocating costs for income or a particular activity according to when the liability is incurred or when there is entitlement or certainty about income.

A charity's gross income for a given financial year will generally determine the type of accounts to be prepared.

Charities with a gross income of £100,000 or more must, in general, prepare accrual accounts. Charities with a gross income of less than £100,000 that are not companies (and do not have any constitutional or other requirements to prepare accrued accounts) may prepare receipt and payment accounts.

Charities with a gross income of less than £100,000 that are charitable companies should prepare fully accrued accounts. A charity may also have to comply with other legislative requirements for example, the Companies Act if they are a charitable company. The Companies Act obliges all companies to prepare accounts comprising a balance sheet and profit and loss account giving a true and fair view of the company's affairs.

It is worth noting that it is open to charity trustees to choose to prepare accrual accounts even if the charity's gross income would allow receipt and payment accounts.

Scrutiny

There are two principal types of external scrutiny to which a charity's accounts may be subject those being independent examination or audit. Independent examination is less rigorous than an audit. Independent examination offers an assurance that nothing has been found that needs to be brought to the attention of readers of the accounts. In terms of the 2006 Regulations, if the term audit is used in a charity's constitution or other governing document then the charity must have its accounts audited. Charity trustees may wish to review their constitutions to either retain the term audit (because the benefit of having accounts audited outweighs the associated costs and extra effort) or amend the constitution to reflect the charities trustees/members intentions regarding external scrutiny. Many funding bodies require charities to have their accounts audited.

The type of scrutiny for a particular charity will be determined by the following factors:-

1. any reference to "audit" in the constitution or governing documents;
2. whether the charity is a company;



3. the charity's gross income and the value of assets held (prior to deduction of liabilities) for the relevant accounting period; and
4. any decision of the charity trustees to carry out an audit.

Audit

An audit is required if the charity.

- has gross income of £500,000;
- prepares fully accrued accounts with total assets which exceeds 2.8 million pounds;
- has gross income of less than £500,000 but its constitution/other enactment (charity trustees) require an audit; or
- has gross income of less than £100,000 and prepares receipt and payment accounts which require an audit by its constitution/other enactment/because its charity trustees want it.

Independent Examination

If the charity does not require an audit it will require an independent examination. There is no de minimis exemption. This applies to charities with less than £500,000 of income unless there is some other reason they require an audit.

Companies

Under the Companies Act 1985, an audit is required at £250,000 of income. Charitable companies with an income of between £90,000 and £250,000 require a report by a reporting accountant. A last minute change in the Companies Act 2006 transferred the audit provisions for a charitable company to Section 32 of the Charities Act. It is set to abolish the rules relating to reporting accountants for charities between £90,000 and £250,000 and the audit threshold is set to rise to £500,000 bringing the position north and south of the border into line with the 2006 Regulations. The timescale for this change has not, as yet, been finalised.



