IN THE MATTER OF SECTION 190
OF THE COMPANIES ACT 2006

OPINION

Introduction

1. I am asked to advise the Charity Law Association as to the application of section 190 of the Companies Act 2006 to transactions whereby unincorporated charities seek to "incorporate." In such situations, the trustees of unincorporated charities typically form a company limited by guarantee of which the trustees become members and directors and to which they then transfer the charity's assets and undertaking, often in exchange for indemnities from the new corporate body.

Legislative Framework

2. Section 190 of the Companies Act 2006 provides as follows:

"190 Substantial property transactions: requirement of members' approval

(1) A company may not enter into an arrangement under which–

(a) a director of the company or of its holding company, or a person connected with such a director, acquires or is to acquire from the company (directly or indirectly) a substantial non-cash asset, or

(b) the company acquires or is to acquire a substantial non-cash asset (directly or indirectly) from such a director or a person so connected,

unless the arrangement has been approved by a resolution of the members of the company or is conditional on such approval being obtained.

For the meaning of “substantial non-cash asset” see section 191.

(2) If the director or connected person is a director of the company's holding company or a person connected with such a director, the arrangement must also have been approved by a resolution of the members of the holding company or be conditional on such approval being obtained.

(3) A company shall not be subject to any liability by reason of a failure to obtain approval required by this section.

(4) No approval is required under this section on the part of the members of a body corporate that–

(a) is not a UK-registered company, or

(b) is a wholly-owned subsidiary of another body corporate.

(5) For the purposes of this section–

(a) an arrangement involving more than one non-cash asset, or

(b) an arrangement that is one of a series involving non-cash assets,
shall be treated as if they involved a non-cash asset of a value equal to the aggregate value of all the non-cash assets involved in the arrangement or, as the case may be, the series.

(6) This section does not apply to a transaction so far as it relates–

(a) to anything to which a director of a company is entitled under his service contract, or

(b) to payment for loss of office as defined in section 215 (payments requiring members' approval).

3. Section 320 of the Companies Act 1985 was, so far as relevant for present purposes, in identical terms.

4. Section 191 provides as follows:

“191 Meaning of “substantial”

(1) This section explains what is meant in section 190 (requirement of approval for substantial property transactions) by a “substantial” non-cash asset.

(2) An asset is a substantial asset in relation to a company if its value–

(a) exceeds 10% of the company's asset value and is more than £5,000, or

(b) exceeds £100,000.

(3) For this purpose a company's "asset value" at any time is–

(a) the value of the company's net assets determined by reference to its most recent statutory accounts, or

(b) if no statutory accounts have been prepared, the amount of the company's called-up share capital.

(4) A company's "statutory accounts" means its annual accounts prepared in accordance with Part 15, and its "most recent" statutory accounts means those in relation to which the time for sending them out to members (see section 424) is most recent.

(5) Whether an asset is a substantial asset shall be determined as at the time the arrangement is entered into."

5. Section 252 of the Companies Act 2006 provides as follows:

"252 Persons connected with a director

(1) This section defines what is meant by references in this Part to a person being "connected" with a director of a company (or a director being "connected" with a person).

(2) The following persons (and only those persons) are connected with a director of a company–

(a) members of the director's family (see section 253);

(b) a body corporate with which the director is connected (as defined in section 254);

(c) a person acting in his capacity as trustee of a trust–

(i) the beneficiaries of which include the director or a person who by virtue of paragraph (a) or (b) is connected with him, or

(ii) the terms of which confer a power on the trustees that may be exercised for the benefit of the director or any such person,

other than a trust for the purposes of an employees' share scheme or a pension scheme;

(d) a person acting in his capacity as partner–

(i) of the director, or

(ii) of a person who, by virtue of paragraph (a), (b) or (c), is connected with that director;

(e) a firm that is a legal person under the law by which it is governed and in which–

(i) the director is a partner,

(ii) a partner is a person who, by virtue of paragraph (a), (b) or (c) is connected with the director, or

(iii) a partner is a firm in which the director is a partner or in which there is a partner who, by virtue of paragraph (a), (b) or (c), is connected with the director.

(3) References in this Part to a person connected with a director of a company do not include a person who is himself a director of the company."

6. Section 1163 of the Companies Act 2006 provides:

"1163 "Non-cash asset"

(1) In the Companies Acts "non-cash asset" means any property or interest in property, other than cash.

For this purpose "cash" includes foreign currency.

(2) A reference to the transfer or acquisition of a non-cash asset includes–

(a) the creation or extinction of an estate or interest in, or a right over, any property, and

(b) the discharge of a liability of any person, other than a liability for a liquidated sum."

7. Section 201 of the Charities Act 2011 provides:

"201 Consent of Commission required for approval etc. by members of charitable companies

(1) In the case of a charitable company, each of the following is ineffective without the prior written consent of the Commission—

(a) any approval given by the members of the company under any provision of Chapter 4 of Part 10 of the Companies Act 2006 (transactions with directors requiring approval by members) listed in subsection (2), and

(b) any affirmation given by members of the company under section 196 or 214 of the 2006 Act (affirmation of unapproved property transactions and loans).

(2) The provisions of the 2006 Act are—

…

(b) section 190 (substantial property transactions with directors etc.)…"

8. Section 66 of the Charities Act 1993 was, so far as relevant for present purposes, in identical terms.

The Problem

9. It will be apparent from the literal wording of section 190 that it applies to the circumstances described in paragraph 1 above since, in those circumstances, the (new) charitable company *prima facie* acquires an asset or assets from the director or from the director and others. Until recently, the Charity Commission had taken the view (which practitioners had followed) that section 190 was of no application because there was no conflict of interest between the trustees of the unincorporated charity and the directors of the newly-incorporated charity. As a result, members' resolutions were generally not passed to authorise the transaction and Commission consent was generally not sought and, even if sought, would probably not have been granted on the footing that it was unnecessary.

Possible arguments

10. It has been suggested to me that it might be possible to seek to construe section 190 (as the Charity Commission had historically done) as if it were limited to circumstances in which there was an actual conflict of interest between the director and the company.

11. The following material is prayed in aid of such an interpretation:

   a. before the 2006 Act, the relevant provision (then section 320 of the 1985 Act) appeared after a sub-heading which read "Restrictions on directors taking financial advantage";

b. the explanatory notes to the 2006 Act refer to the provisions of which section 190 forms a part as being designed to deal with a "particular situation in which a director has a conflict of interest" (para 379). Para 402 of the notes also states that substantial property transactions are those in which the company "buys or sells" a non-cash asset (where "charity incorporations" tend to involve gratuitous transfers or transfers in exchange for indemnities);

c. in NBH Ltd v Hoare [2006] EWHC 73 (Ch) Park J commented (in the context of section 320 of the 1985 Act) that it "and other sections originally enacted at the same time are intended to protect companies against exploitation by directors to the financial benefit of the directors and the financial detriment of the companies."

12. Regrettably, in my view, there is no basis for interpreting section 190 in any way other than in the literal sense summarised at paragraph 9 above.

13. First, I think that, as a matter of statutory construction, one cannot achieve a limitation of the application of section 190 merely by construing particular words. One has to read extra words into the statute. It is well established that it is not permissible to read words into an enactment unless three matters can be shown: (1) the intended purpose of the statute or provision in question; (2) that by inadvertence the draftsman and Parliament failed to give effect to that purpose in the provision in question; and (3) the substance of the provision Parliament would have made, although not necessarily the precise words Parliament would have used, had the error been noticed: *Inco Europe Ltd v First Choice Distribution (A Firm)* [2000] 1 WLR 586 at 592 per Lord Nicholls. In the case of section 190, one would have to say that Parliament's purpose was to require members to approve certain types of substantial property transaction between companies and directors but not all such transactions. Given the careful way in which substantial non-cash transactions have been defined, I think that it would be difficult to persuade a Court that Parliament had intended only to apply the provision to transactions in which there was an actual conflict

of interest but failed to do so through inadvertence. Indeed, one can foresee a counter-argument to the effect that the decision whether to approve all substantial property transactions was entrusted to the membership precisely to avoid directors making the decision for themselves as to what did or did not require the members' approval.

14. Second, I think that a Court would be slow to interfere with the literal meaning of section 190 where to do so could have consequences in ordinary commercial contexts. The real mischief in "charity incorporation" cases is the need to get Commission consent since usually it will be possible to show that the members have approved or affirmed the transaction on Duomatic principles if not by reference to a resolution of a meeting (see In re Duomatic Limited [1969] 2 Ch 365). I do not think that a Court would be quick to limit the application of a section of the Companies Act (designed to protect all companies) simply to accommodate a problem which befalls charities by reason of a provision in the Charities Act.

15. It has also been noted the definition of a substantial non-cash asset proceeds (at least in part: see section 191(3)(b)) on the assumption that the company in question is limited by shares, rather than (as tends to be the case in the context of charities) by guarantee. However, I cannot see any basis on which to limit the application of section 190 to companies limited by shares since there are no obvious reasons of policy why shareholders should be given greater rights to control directors dealing with company assets than members of guarantee companies. One does occasionally find charitable companies limited by shares and it would be curious if they should be caught by section 190 whereas guarantee companies (whether charities or not) should escape it.

16. It has also been suggested that section 190 does not apply where the transfer is made by a director in his capacity as a trustee (or as one of several trustees). The words do not make any such distinction. I cannot see any reason of policy why it should matter whether the property derives from a trust of which the director is trustee or from the director beneficially. Nor can I see any reason to distinguish between cases where the transfer is from the director alone or from

the director as one of several transferors. Were section 190 to be so construed, its effect would be easily circumvented in many commercial situations.

17. Finally, the question has been raised whether section 192 has the effect of taking "charity incorporations" outside of the scope of section 190. Section 192 provides (so far as relevant) that "Approval is not required under section 190 … for a transaction between a company and a person in his character as a member of that company." This seems principally designed to cover the issue or redemption of shares. I cannot see how it can be said that a transfer by a director as a trustee of an unincorporated charity can be said to be "in his character as a member" of the recipient company.

18. I therefore regret that a "charity incorporation" contravenes section 190 of the 2006 Act and/or section 201 of the 2011 Act if it has not been approved or affirmed by the members with (in either case) the prior consent of the Commission.

Effects of this Construction

19. I accept that this construction appears to catch non-cash gifts made by directors to charities. My initial reaction was that this did not matter since no charity would want to avoid a donation or any other transaction by which it benefited and there would be no gain to the director for which he might have to account pursuant to section 195(3)(a) (discussed further below). Although the restriction of section 190 to non-cash assets seems to render it unlikely that gift aid donations by directors to charitable companies could ever come within the scope of section 190, I did worry whether (say) relief from capital gains tax on a donation in kind might give rise to a liability to account to the charity for the relief obtained. However, I think that the words "for any gain that he has made … by the arrangement or transaction" in section 195(3)(a) must look at the totality of the transaction (such that any gift-aided donation would still represent a net loss to the donor). Similar reasoning would therefore also protect a donor who transferred assets to a charity of which he was director at

an undervalue (assuming the governing instrument to permit such a transaction at all).

20. I further accept that this construction of section 190 bites not only on "incorporations" but also on mergers where an unincorporated charity transfers non-cash assets to a charitable company and where some of the transferring trustees become directors before the transfer takes place or where the board shares common trustees. In fact, I wonder whether any form of reading of section 190 which limited it to circumstances of conflict of interest could save mergers from its effect: a merger will very often involve some sort of conflict of interests or loyalty. Indeed, the Commission has often been asked to make Orders to facilitate such mergers pursuant to what is now section 105 of the 2011 Act. (I see no reason why such an Order might not also constitute written consent under what is now section 201 of the 2011 Act even if not expressed as such and no-one turned their minds to the need for that particular approval. Such mergers might therefore be saved through a combination of the Duomatic principle and an Order made under what is now section 105).

21. I accept that the conversion of foundation schools to academies might also be caught by this construction of section 190. They are, in law, simply a particular form of transfer of assets from an unincorporated to an incorporated body. So it follows that they should be treated just the same.

22. I have given some thought to the question whether the mere vesting of trust property in a corporate trustee (where it had previously been held on trust by individual trustees) could come within the scope of section 190. I confess to having found this question more difficult but I have ultimately concluded that the word "acquired" in section 190 is probably broad enough to include the vesting in a corporate body of trust property: see Congreve and Congreve v Inland Revenue Commissioners [1946] 1 All ER 170 at 183. Vesting is a means of conveying the legal title to a new legal person. I cannot see how one can avoid the conclusion that the legal title is thereby "acquired" by the new trustee. Although I can see that, as a matter of policy, whether or not a

corporate body becomes trustee of property might be a matter less likely to give rise to concern to the members of the company, it is possible for a trustee to incur liabilities in excess of the trust funds out of which he is entitled to be reimbursed. Thus, one could imagine a family trust fund of which a director of a commercial company and his wife were trustees. They might vest the trust property in the company and the company might then incur a liability (*qua* trustee) in excess of the trust fund. One can see why the members ought to be able to given an opportunity to approve such a transaction as much as they ought to be able to approve any other transaction between the company and the director.

<u>Limits of the Application of section 190</u>

23. Given the significance of my construction of section 190, it is worth spelling out the limits on the circumstances in which the section does apply to "charity incorporations."

24. First, it does not apply where there is not a transfer of a substantial non-cash asset. In the case of very small charities (with non-cash assets under £5,000 or whatever the relevant threshold was at the time in question: £1,000 was the figure in 1980), the section does not apply. It also does not apply where the transfer is less than 10% of the asset value of the company (unless the asset exceeds £100,000 in value – or whatever the relevant threshold was at the time in question: £50,000 was the figure in 1980). As noted above, in the case of a company limited by guarantee, there will be no shareholding and where the company is newly-incorporated it will not have any accounts. I fear, however, that the consequence of this is that its asset value is nil and the 10% threshold will therefore always be met if the property transferred exceeded £5,000 (or the threshold at the relevant time). But very small charities may escape section 190.

25. There are also time limits as to what transactions are vulnerable where there has been a contravention. Section 190's statutory predecessors (section 320 of the Companies Act 1985 and before that section 48 of the Companies Act 1980) did not first come into force until 22 December 1980 and did not apply

to transactions entered into before that date: see section 65(7) of the 1980 Act. There is therefore no reason to impugn any transaction before 22 December 1980.

26. The need for Commission consent did not appear until it was inserted as section 30B of the Charities Act 1960 by section 41 of the Charities Act 1992 with effect from 4 February 1991. Thus it seems likely that any transaction pre-dating 4 February 1991 will be capable of being saved on Duomatic principles, especially if the members were directors of the charitable company.

27. The civil consequences of breach of what is now section 190 of the 2006 Act are set out in what is now section 195. By section 195(2), the transaction is voidable at the suit of the company unless certain circumstances apply. In most cases, the company will not want to avoid the transaction and could affirm it (for which purpose Commission consent is required: see section 201(1)(b) of the 2011 Act). Many transactions could therefore now be saved. There is no express time limit for affirming a transaction. For the reasons given below, I am not sure that it is necessary to do so more than 12 years after the transaction but some charities may wish to do so for the avoidance of doubt.

28. Since an attempt to avoid the transaction would, I think, be a claim based on the statute, it seems to me that it would be a claim on a specialty and therefore statute-barred after 12 years from the date of the contravention: see section 8 of the Limitation Act 1980.

29. Of the various statutory bars to avoiding the transaction, one is that rights acquired in good faith, for value and without actual notice of the contravention by a person who is not a party to the arrangement or transaction would be affected by the avoidance. That will presumably often be the case where the charitable company starts to deal with its assets after incorporation – especially if it operates any form of business (which is precisely the sort of situation in which one might have expected incorporation to have been considered important). So in many cases it will not now be possible to avoid the transaction anyway, even if 12 years have not passed.

Relief

30. In light of my conclusions, the question arises as to what should happen next. In that regard, I am particularly conscious of the potential consequences for directors personally who have unwittingly been party to a contravention.

31. Section 195(3) of the 2006 Act provides that, whether or not the arrangement or any relevant transaction has been avoided, certain persons are liable (a) to account to the company for any gain that they have made directly or indirectly by the arrangement or transaction, and (b) (jointly and severally with any other person so liable under the section) to indemnify the company for any loss or damage resulting from the arrangement or transaction. The relevant persons include (inter alia) any director of the company, any person with whom the company entered into the arrangement who is connected with a director of the company and any other director of the company who authorised the arrangement or any transaction entered into in pursuance of such an arrangement. There are certain exclusions, the most relevant of which is that a person connected or director who authorised the transaction (but not one who entered into it) is not liable if he shows that, at the time the arrangement was entered into, he did not know the relevant circumstances constituting the contravention. This suggests that, at least for directors who were on both sides of the transaction, there is a risk of being asked (for example) to indemnify the company if the business transferred to it by the incorporation process subsequently fails. Similarly, one can imagine circumstances in which loans might be novated to the corporate charity and security transferred on incorporation only for the value of the security subsequently to prove insufficient. No doubt substantial questions of causation might arise in any resulting claims against the director, especially if the claim was brought some time after the transaction. Moreover, it seems to me that any claim made by a corporate charity against a director arising out of a breach of section 190 would be barred after 12 years for the reasons set out at paragraph 27 above (or perhaps 6 years in so far as it sought to recover money: see section 9 of the Limitation Act 1980). However, these considerations will offer little comfort to many directors who have unwittingly been involved in a contravention.

32. It seems to me that, in circumstances where it has always been assumed that section 190 (or its predecessors) did not apply to "charity incorporations" (or mergers), the resulting technical breach ought to be excused by the Commission pursuant to section 191 of the Charities Act 2011 where the only shortcoming was the failure to obtain Commission consent.

33. The position where there was also a failure to obtain the approval of the members (and where the principle in Duomatic cannot be relied upon) is more difficult since there might (although it seems unlikely in practice) have been some reason why a member may have objected which probably requires at least some investigation as to whether that might have been so. I have briefly considered whether the Commission's power to grant relief is available even where the failure of the charity trustee is a "pure" breach of a company law requirement. Section 191 of the 2011 Act is available (by section 191(1)(a)) to a charity trustee or trustee for a charity so that includes the directors of a charitable company (see section 177 of the 2011 Act). Section 191(2) allows for the Commission to grant relief (provided that the relevant conditions are satisfied) where a charity trustee is or may be personally liable for a breach of duty committed in his capacity as a charity trustee. My preliminary view is that the Commission's power to grant relief would therefore be available where there was a breach of the Companies Act by a director of a charitable company (on the footing that the breach was one committed in the director's capacity as a charity trustee), notwithstanding that the duty in question was one which is imposed on all company directors (not just charity trustees). If I am wrong about that, the Court would of course have power to grant such relief pursuant to section 1157 of the Companies Act 2006. However, neither the Court (nor, by analogy, the Commission) can excuse a director of a charitable company from the obligation to account for any gain pursuant to section 195(3)(a) of the 2006 Act: see Guinness v Saunders [1990] 2 AC 663.

34. It therefore seems to me that the best comfort which can be given to directors of charitable companies who may unwittingly have breached section 190 (or its predecessors) is some sort of public statement by the Commission that

where the directors acted in good faith and did not personally benefit (beyond the benefit inherent in ceasing to be personally liable for the debts of an unincorporated charity):

a. consent will generally be available where the members now wish to affirm a relevant transaction;

b. relief will ordinarily be available and where the members did consent (or have since affirmed the transaction), whether formally or informally, and the only failure was a failure to seek Commission consent; and

c. in cases in which member consent was not obtained (formally or informally) and where it cannot now be obtained, relief would (subject to the Commission's view) ordinarily be available if there was no reason to suppose that the members did not or would not have approved the transaction had they been asked or (if the Commission thinks that a breach of a "pure" Companies Act requirement is beyond the scope of the Commission's power to grant relief) the existence of the Court's jurisdiction to grant relief could be helpfully signposted.

35. If the Commission agrees that mergers which required an Order pursuant to what is now section 105 of the 2011 Act can be saved by that Order, it would no doubt also be useful to say so. But it may be more prudent simply to give consent to an affirmation or to grant relief in such cases rather than prolong any doubt as to whether a section 105 consent can operate as a written consent pursuant to section 201.

Other questions

36. I am also asked whether the duty to avoid conflicts of interest imposed on company directors impinges on the ability of directors to act *qua* members in approving pursuant to section 190 a transfer of assets on a "charity incorporation." That prohibition is found in section 175(1) of the 2006 Act

which provides "A director of a company 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."

37. However, leaving aside for present purposes the provisions whereby such a conflict may be authorized:

    a. section 175(3) provides that: "This duty does not apply to a conflict of interest arising in relation to a transaction or arrangement with the company"; and

    b. section 175(4)(a) provides that "This duty is not infringed … if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest."

38. As to (a), this appears designed to carve out of the general duty specific transactions which are governed instead by section 177 (which requires the director to disclose his interest *in a particular transaction* to the board). So, subject to the articles of the company, all that is required in the case of a conflict regarding a transaction is disclosure to the board. Even that is not required under the general law if all the other directors know about it (as would be common in a "charity incorporation" case): see section 177(6)(b). Subject to the articles of the new charitable company, it is therefore difficult to see how sections 175-177 could impinge on the ability of a director, *qua* member, to approve the transaction for the purposes of section 190.

39. As to (b), although one can imagine an argument to the effect that whenever a charity incorporates it is spending charity money to undertake an exercise which is very often for the trustees' own benefit, it seems to me difficult to say that this constitutes a situation which would reasonably be regarded as a conflict of interest. Indeed, this may be a question to be answered by reference to the governing instrument of the unincorporated charity (and the duties of the unincorporated charity trustees) and not the recipient new corporate charity (and the duties of the new directors).

40. I do not therefore see any difficulty with the members giving their approval under section 190 in a "charity incorporation" case where the members are also the directors.

41. I am also asked whether section 190 has any application to a transfer of assets by an unincorporated charity to a Charitable Incorporated Organisation ("CIO"). Happily, the answer to that question is in the negative since (a) a CIO is not a "company" within the definition of section 1(1) of the Companies Act 2006 and (b) section 190 is not a provision of the 2006 Act which has been made applicable to corporate bodies other than companies within the section 1(1) definition: see section 1043 of the 2006 Act, the Companies Acts (Unregistered Companies) Regulations 2007/318, the Companies and Limited Liability Partnerships (Accounts and Audit Exemptions and Change of Accounting Framework) Regulations 2012/2301 and the Unregistered Companies Regulations 2009/2436).

42. Finally, I do not think that the questions raised by my instructions can usefully be the subject of a reference to the Tribunal because (a) the central question is a question of construction of the Companies Act 2006 (and not a matter of charity law) and (b) I don't myself see much scope for argument on that principal question.

Conclusion

43. I should be happy to advise further if so instructed.

Matthew Smith
Maitland Chambers
7 Stone Buildings
Lincoln's Inn
London
WC2A 3SZ

16 April 2013

IN THE MATTER OF SECTION 190
OF THE COMPANIES ACT 2006

OPINION

Farrer & Co LLP
66 Lincoln's Inn Fields
London
WC2A 3LH

Tel: 020 7539 7272
Fax: 020 7240 5780

Ref: JAS

Charity Law Association