

Business Law Update

June 2006

Company Law Reform Bill - An Update

As noted in the last edition of BLU the Company Law Reform Bill (the 'Bill'), heralding major changes to company law, was published in November of last year. The Bill has had a very hard time of it in the Lords, with lengthy debate on many of the more controversial areas, such as directors' duties and derivative claims. The Bill has now been passed, together with amendments, to the House of Commons and at the time of writing was about to have its second reading debate in the Commons. This article highlights and discusses some of the changes that have been made.

Directors' Duties

One of the key things that the Bill has done is to codify (i.e. set out in statute) directors' duties. This in itself need not lead to a change to the current law, but in fact the basic duty of directors has been tampered with. Section 156 of the Bill sets out the overriding duty of a director, which is to act in a way which a director considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole. In fulfilling this duty, directors must take account of a variety of factors, including employees, the community and the

environment. After much concern and debate on this section, changes have been made that are intended to clarify: (i) that the need to have regard to certain factors is subject to the overriding duty; and (ii) that the list of factors is not exhaustive. These amendments are certainly welcome, although there remain concerns over whether the drafting achieves what it sets out to do and over the lack of clarification on the relevance and weight to be attached to particular factors being a matter for directors' business judgement. During the Report Stage there was much urging for a return to the present common law position - i.e. a duty to act in good faith 'in the best interests of the company' and that any other factors that have to be taken into account should be set out in guidance, rather than fixed in legislation. The government has resisted the pressure on the wording of the basic duty, although the DTI will be producing guidance rules on this area to assist.

Shareholder Derivative claims

With respect to derivative claims (under which a shareholder, acting as the company, may bring an action against a director for breach of duty), there was concern that the drafting in

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the Bill would lead to the right to bring a derivative claim being abused by shareholders and an unjustified increase in the number of claims. The amendments have therefore tightened up the provisions, for example requiring the courts to dismiss non-meritorious applications at an early stage.

Narrative reporting in the accounts

The requirements for narrative reporting have been streamlined so that the obligations for quoted

companies are now more closely aligned to those for unquoted companies. The government has decided not to reinstate the OFR. Under the amendments proposed all companies (other than small companies) will need to produce a Business Review - the purpose of which is to inform shareholders and help them assess how the directors have performed their duty under section 156 (duty to promote the success of the company). Companies will be exempt from disclosing information that is seriously prejudicial to the company's interests. Quoted companies will need to ensure that, to the extent necessary for an understanding of the development, performance or position of the company's business, their Business Review includes the main trends and factors likely to affect the future development, performance and position of the company's business, and information about environmental matters, the company's employees, and social and community issues.

New draft clauses on reporting and liability

New draft clauses have been published on reporting and liability. A director will only be liable for statements or omissions in the directors' report, directors' remuneration report and any summary financial statement derived from those reports if he knew the statement was untrue or misleading or was reckless as to whether it was so, or he knew the omission to be dishonest concealment of a material fact (i.e. the principles laid down in the Caparo case). He will also only be liable to the company.

New Draft Clauses relating to the Transparency Directive

New draft clauses have also been published on disclosures under provisions to implement the Transparency Directive ('TD'). An issuer, whose securities are traded on a regulated market, will be liable for statements disclosed as required under TD implementation. An issuer will only be liable if a person exercising managerial responsibilities within the issuer in relation to the report knew the statement to be untrue or misleading or was reckless to whether that was so, or knew the omission to be dishonest concealment of a material fact. In addition the issuer will only be liable to

an individual investor or other third party if he had reasonably relied on the statement for investment purposes, and suffered loss as a result of the statement or omission.

Other significant amendments

Amending the law in the future

The power contained in the Bill to amend the law in future to adapt it to a changing environment, without going through the usual Parliamentary processes, has had a very rough ride. Although put in as a well-intentioned response to businesses' frustration that changes to company law take years to effect, for many the proposal went too far. It was seen not only by the opposition parties, but also by commentators, as giving too much power to the executive, and the government has now withdrawn that section of the new law (although it will make some specific proposals for certain parts of the rules to be more flexible).

Enfranchising indirect investors

Another area that was discussed in detail in Report Stage was that of indirect investors, and whether the government has gone far enough in 'enfranchising' indirect investors (nearly 50% of all private shareholdings are now administered by nominees - there are 24 million nominee-based shareholdings against 26 million certificated shareholdings.) The Bill contained a reserve power for the Secretary of State to make regulations forcing companies to insert particular provisions in their Articles, but many felt that this did not go far enough. An amendment has now been made providing that all listed companies are deemed to have a provision in their articles to enable members to nominate another person or persons as entitled to receive documents and information and to enjoy or exercise all or any specified rights of the member in relation to the company. However, this amendment is likely to result in much lobbying by interested parties and at the time of writing it is felt unlikely that the government will keep the amendment in.

Company Names - A Brief Reminder

Choosing the name of your company is a key, and often personal, decision. However, it is important to remember that although generally you have freedom of choice in choosing your company's name, there are restrictions imposed by legislation. For example, a name may be rejected if it is the same as that of an

existing registered company or if, in the opinion of the Secretary of the State, its use would constitute a criminal offence, or it is offensive.

Once your company name has been registered and you have received your certificate of incorporation, you must paint or affix the name outside every office or

place where you carry on business, in a conspicuous position and in letters easily legible. In addition to this, you must mention the company's name in legible characters in various places, such as in all business letters of the company and in all its notices and other official publications.

Having a name registered is no guarantee of keeping it for good. The Secretary of State has the power to order a change of name in certain circumstances, such as within 12 months of registration, if the name is too like a name appearing in the index of names at the time of

registration or is the same as a name which should have been in the index at that time. Alternatively, you may decide yourself that you would like to change the company's name - in order to do this you will need to pass a special resolution of the shareholders (requiring a 75% majority).

If you would like further information on this subject, please see the article titled 'Business Names' on the knowledge base section of our website http://www.davenportlyons.com/html/knowledge_base/running_your_business/business_names.html.

The Small Business Service - Is It Delivering The Goods?

The Small Business Service (SBS), an agency of the Department of Trade & Industry, was set up in 2000 and charged with turning Britain into an enterprise society. The SBS states on its website that it has a simple vision - 'we want the UK to be the best place in the world to start and grow a business'. How necessary this is is emphasised by the relevant statistics: there are 3.5 million businesses in England, with 99% of them being 'small' businesses with under 50 employees. Small and medium-sized enterprises account for 51% of business turnover in England and employ 57% of the private-sector workforce.

However, the SBS has been repeatedly reorganised, and a recent report by the National Audit Office (NAO), the independent public spending watchdog, has not been overly glowing. Whilst recognising the positive contribution made by the SBS in championing small businesses, the report uncovers a mass of inefficiencies. The report focuses on three key roles the SBS is expected to fill: (i) supporting the government drive for better regulation; (ii) access to finance; and (iii) encouraging 'joined-up' government services for small businesses. In the first category the SBS appears to have made little impact on slashing red tape, apart from the introduction of single commencement dates for new regulations. Six of the eleven departments that were questioned were unable to say what impact the SBS had had on their deregulation efforts, and according to the report there was no systematic approach in setting priorities.

In terms of access to finance, governments have repeatedly tried to fill gaps faced by start-ups and small growing businesses. The flagship policy is the small companies loan guarantee scheme, aimed at the 150,000 small businesses that the SBS believes face

problems raising unsecured funds. In the past year this has helped 5,800 companies but the default rate is almost nine times that of commercial lenders and the danger is that the scheme damages competitors. (Information on this scheme can be found at <http://www.businesslink.gov.uk/bdotg/action/detail?r.s=sl&type=RESOURCES&itemId=1074447105>.) Several schemes to provide equity finance have also encountered problems, and again the NAO criticised the failure of the SBS systematically to monitor the impact in ways that would encourage the private sector to fill the gap.

At least the SBS fared slightly better in its third role. The Business Link network is praised by organisations representing small business and has become better known and appreciated by them - however, the SBS has lost control of the network to the government's regional development agencies.

The biggest criticism overall is that the SBS does not measure its performance with precision and thus cannot demonstrate that it is achieving its objectives. Unable to measure the impact of the £2.6 billion the government spends on supporting small businesses, the agency has now commissioned consultants to produce a common set of performance indicators. The Director-General of the British Chamber of Commerce, David Frost, made his feelings fairly clear on this: "When an organisation has to resort to using taxpayers' money to demonstrate its effectiveness, that is the time to question whether it should continue." He also noted that: "the 25 government departments surveyed simply did not have confidence in the SBS's agenda for small business issues."

It will be interesting to see what impact this report has on the SBS's future.

Changes To The Takeover Regime

As discussed in the last edition of BLU, the implementation of the EU Takeovers Directive, required by 20 May 2006, has led to numerous changes to the Takeover Code. In addition to the changes required by the Directive, the Panel has also taken the opportunity to consult on various other changes to the Code, and amendments have been made accordingly. The revised Code took effect from 20 May 2006, in conjunction with the Takeovers Directive (Interim Implementation) Regulations 2006 - these regulations were speedily drafted and passed due to the fact that the Company Law Reform Bill, whose clauses dealing with the implementation of the Takeovers Directive were meant to have been brought into force in advance of the rest of the Bill by 20 May 2006, has been so heavily debated in the Lords that the deadline was never going to be met. In this article we examine the overall picture, and then examine the changes in brief looking first at the changes brought about by the Directive, then the changes to dealings in derivatives and options (control issues), and finally the changes resulting from the abolition of the Substantial Acquisition Rules (SARs).

Overview

The most important point to bear in mind is that although the volume and detail of the changes to the Code are fairly considerable, in practice only a small number of them will impact significantly on mergers and acquisitions practice. The Takeovers Directive was substantially based on the UK model for takeover regulation, so much of the Code already complied with the Directive. During the consultation process the Panel stated that so far as is possible within the new statutory framework it intended to keep disruption to the current UK regime to a minimum. As a result, the practical, day-to-day impact of the legislative changes is small and it is expected that the Panel's relationship with the regulated community will be largely unaffected. The Panel will continue to regulate takeover activity in the UK with a flexible approach, offering 'speed and certainty in decision-making and seeking to ensure compliance with the Code through consensus with the parties involved.'

One of the most significant consequences of the Directive has been the introduction of the concept of shared jurisdiction, whereby supervisory authorities in different

EEA States will each regulate different aspects of the same transaction. This, however, will only apply where an offeree company is incorporated in one EEA State but not admitted to trading in that EEA State, although is admitted in another. Takeovers and mergers where this applies will therefore be affected by this change, but obviously this will have no impact on a straightforward UK transaction.

Changes resulting from the implementation of the Directive

Implementation has been achieved through two routes - amendments to the Code, and the coming into force of the Takeovers Directive (Interim Implementation)

Regulations 2006. As their name implies, the Regulations are a temporary measure, to be replaced in due course by Part 22 of the Company Law Reform Bill. Until the enactment of this Bill, a two track regime will be in operation - where a particular transaction is outside the scope of the Regulations, for example, a takeover offer for an AIM-listed company, the Code rules and the Panel will continue to operate on a non-statutory basis as they did before 20 May. When the Bill becomes law, the provisions contained in it will apply more widely to other types of transactions

including takeovers of public companies whose shares are not traded on a regulated market as well as mergers.

- The Panel's status has been underpinned by legislation, giving the Panel authority over transactions to which the Takeovers Directive applies.
- For takeovers that fall within the scope of the Directive, the Panel has greater powers to enforce Code Rules and it is a criminal offence for an offer document or defence circular not to contain all the information required by certain Code Rules.
- Offeror and offeree company documentation are subject to extended content requirements, particularly regarding the transaction's strategic effect and its implications for employees.
- A number of new obligations fall on both offeror and offeree company with regard to the publication and distribution of announcements and documentation.
- New provisions govern the thresholds and timing

Although the volume and detail of the changes to the Code are fairly considerable, in practice only a small number of them will impact significantly on mergers and acquisitions practice

restrictions for squeeze-out and sell-out procedures following a takeover of a UK-registered company admitted to trading on a regulated market (not AIM).

- There are tighter restrictions on a target taking action to frustrate a bid, and a company, provided its articles of association meet certain requirements, can opt-in to the Directive 'breakthrough' provisions, which invalidate certain restrictions on transfers of securities and exercise of voting rights, where these operate as a barrier to takeover.

Dealings in derivatives and options

Broadly speaking, all dealings in long derivatives and options will be treated as dealings in the underlying shares. This means that long derivatives will count in triggering an obligation to make a Rule 9 offer and will be subject to the Rule 5 restrictions on acquisitions.

SARs

These have been abolished, following the Panel's consultation after which it concluded that the Rules no longer fulfil a useful function. It will therefore now be possible to carry out a market raid to acquire up to 29.9%

of a company in one fell swoop. Note, however, that the Code Committee does not believe that the abolition of the SARs will see a return to the market raids of the late 1970s that they were introduced to combat. Investors are perhaps less eager to sell out in a raid as they risk losing out on any subsequent offer premium. Note also that SAR 4, which sets out procedures for tender offers, will be retained and set out in a new Appendix 5 to the Code. Panel consent will be required for any tender offer, although this will normally be granted in the same circumstances as those in which tender offers are currently permitted.

Conclusion

Various other miscellaneous amendments have also been made to the Code, such as those consequential on recent changes to the Listing Rules. However, as stated above, whilst all the amendments to the Code are fairly daunting in their volume and range, very few will have a material impact on existing mergers and acquisitions practice - in most cases, the changes impact only on the detailed compliance with the Code.

Recent Commercial Agency Cases

Many commercial arrangements operate as an agency relationship. A legal relationship of principal and agent exists when a principal authorises his agent to act on his behalf. The terms of the agency arrangement may be recorded in a written agreement, however frequently there is no written agency agreement or it does not adequately deal with the terms of the agency arrangement. Consequently, the common law has traditionally provided guidance as to the respective rights and obligations of the parties in an agency relationship. These common law rules have been formalised by the Commercial Agents (Council Directive) Regulations 1993 (the '**Regulations**') which implemented the EC Council Directive 86/653/EEC of 18/12/86 on the co-ordination of the laws of Member States relating to self-employed commercial agents (the '**Directive**').

The Regulations set out the respective rights and obligations of the principal and its commercial agent, dealing with a range of commercial points including, the obligations on both the agent and the principal to act dutifully and in good faith in respect of the other, and the agent's right to compensation upon the termination of

the agency agreement. Although the Regulations provide a useful framework to establish the respective rights of the agent and principal, a series of cases in this area have highlighted the fact that the Regulations are not sufficiently clear and remain open to interpretation in many respects.

Two recent cases, *Poseidon Chartering BV v Marianne Zeeschip VOF and others (2006)* ECJ ('**Poseidon**') and *Graham Lonsdale v Howard and Hallam Limited (2006)* CA ('**Lonsdale**'), have served to clarify the application of the Regulations in two key areas: how much compensation is an agent entitled to on termination of the agency agreement and when is an intermediary an agent for the purposes of the Regulations?

In *Lonsdale*, the Court of Appeal reconsidered the 'Two Year Compensation Rule'. Under the Regulations, subject to an exception where indemnification is provided for, an agent is entitled to compensation for any damage suffered by the agent as a result of the termination of his relationship with the principal. 'Damage' is not fully defined in the Regulations and case law has failed to provide a definitive method of

assessment of damages in such cases. In a number of cases, and as argued by the agent in *Lonsdale*, there has been an assertion that the agent should be entitled to two years' gross commission by way of compensation. The 'Two Year Compensation Rule' derives from the French Courts' interpretation of the Directive and has been adopted as guidance in some cases in England. The Court of Appeal in *Lonsdale* took the view that the 'Two Year Compensation Rule' is too broad to deal adequately with the range of cases likely to come before the English Courts. The Court of Appeal determined that the damage suffered by the agent is the loss of the agency business - in other words, what is the value of the agency business (in particular, the accrued goodwill) at the time of termination?

Another key issue in applying the Regulations is the

definition of commercial agent - how do the Courts determine whether an intermediary in a transaction is, in fact, a commercial agent and therefore subject to the Regulations? The ECJ ruled in *Poseidon* that the decisive feature in determining whether an intermediary is a commercial agent is that the intermediary's authority to negotiate on the principal's behalf should be continuing. Whether an agent's authority is continuing is not always easily determined, however, a factor such as the number of transactions concluded by the intermediary is generally an indicator of the agent's authority. Even where a single contract is extended annually over a number of years, as in *Poseidon*, a commercial agency relationship can still exist if the intermediary has its principals' continuing authority to negotiate renewed contracts.

"Growing Old Lawfully"

John Hayes

Many readers will know that Regulations introducing a general ban on age discrimination in employment and vocational training come into force on 1 October 2006 and all businesses should be preparing for their impact, now.

Age discrimination is one of the biggest changes to hit UK employment law legislation in years and all employers will now need to become "age sensitive" if they are not already!

Why are the changes so important?

First, they apply to **all ages of employee** (or prospective employee) and so protect young and old alike (whereas in America only the over 50s are protected). It will be as unlawful to pass over a young employee for a promotion because they are deemed 'not ready' as it will be to fail to promote an older worker because they are 'past it' if the reasons for the non promotion are aged based assumptions rather than merit. The old-style service based tenure requirements are likely to prove unlawful.

Second, **employers owe obligations to non employees as well as employees** if they are connected to the employment relationship - i.e. during the recruitment process or in giving a reference. In Ireland, where age discrimination has been in place

for some time it is the area of recruitment where employers have had most difficulty - where they reject certain applicants because they are seen to be too old. Employers should focus on a candidate's 'experience' and qualifications for the job rather than his/her age. The more cautious employers will remove 'D.O.B' from their application forms and keep this date as part of the voluntarily supplied diversity monitoring information such as ethnicity or religious belief.

Third, length of service can still be used to calculate or award benefits provided the length of service requirement is for 5 years or less (or the length of service requirement mirrors a similar requirement in a statutory benefit). This will make many enhanced redundancy policies discriminatory.

Fourth, the Government has set a default retirement age of 65 which will operate for most employers. However, many private employers ask employees to leave at either 55 or 60 and this policy will now have to be objectively justified (which will be very difficult to do).

Fifth, businesses who want to retire employees even at the statutory or contractual retirement age will have to follow a complicated 'duty to consider' procedure before any dismissal takes effect if the employee asks to stay on. This involves allowing the employee to have their say before they are dismissed.

Avoiding common mistakes

- Employers will have to be careful about rejecting applicants because they are deemed to be 'over-qualified' if the reason for

the rejection is essentially age-based.

- Some employers who recruit from the 'milk round' will have to be careful - they should also think about recruiting from (for example) the Open University.
- Think about justifying service-based benefits - such as sabbaticals - by being able to prove that this policy improves staff retention.

Justifying Discrimination

It will be possible for employers to defend claims of age discrimination if they can prove that a given policy can be objectively justified because it is a legitimate means of achieving a genuine business aim (for example encouraging staff retention) and the policy is not 'disproportionate.' In

practice, this will be difficult to do for most private employers because they will need to have reports and statistics to demonstrate that they considered the legitimate business aim before a policy was introduced.

It is far better not to discriminate in the first place.

Exposure

The exposure to employers for discrimination on the grounds of age may well be more costly than any other area of discrimination. The reason for this is two-fold:

- (a) in many companies age based discrimination is far more prevalent than other forms of discrimination. How many times has a new management team got rid of 'the old guard' within 6 months of arriving on the scene?

This could now be unlawful unless it can be objectively justified;

- (b) many white collar older workers may be dismissed at the age of 55 when they are on a good salary and benefits. The potential exposure to the employer is many years loss of wages if, in effect, they can't get another job (or can only get a poor substitute). Six figure awards of damages could become all too common.

The solution

The solution is relatively straightforward: recruit and retain staff on merit rather than taking into account considerations of age (or sex, race, disability, religious belief or sexual orientation!).

Changes To The Inheritance Tax Treatment of Trusts

Emma Lampier

There has been a great deal in the press about the proposed changes to the taxation of trusts, introduced by the Finance Bill following March's budget, and the uproar that this has caused in the Private Client and Tax Planning industry. This article summarises those changes following the government's further amendments (issued on 8 June 2006) to soften the blow of the proposed legislation, which has been described as 'swingeing'.

The cause for concern is the move to bring nearly all trusts within the tax rules which previously only applied to discretionary trusts (being trusts in which no-one is entitled to income or capital). These are known as the relevant property rules.

The relevant property rules

The regime of charges comprises an initial upfront charge, anniversary charges every 10 years and an exit charge when property leaves the trust. The initial charge applies

if the value of the assets placed in trust exceeds the settlor's nil rate band (currently £285,000). For lifetime transfers the rate is 20%, with further tax to pay if the settlor does not survive by 7 years. For transfers on death the rate is 40%. The 10 yearly anniversary charge has a maximum of 6%. The exit charge is a proportion of the 10 yearly charge.

Existing trusts

The two main types of trusts affected are accumulation and maintenance Trusts ('A&M Trusts') set up for children or grandchildren under the age of 25 and life interest trusts (also known as interest in possession trusts).

Under the original proposals A&M trusts become relevant property trusts unless children/grandchildren are entitled to capital and income at 18. The amendment introduces special charges for the new defined 'age 18-to-25' trusts, with a proportionate exit charge for assets leaving the

Contacts

This Bulletin is designed to provide a summary of the subject matter. It does not purport to be comprehensive or a substitute for specialist legal advice in individual circumstances.

If you would like any further information on these or any other business-related topics please contact one of the Partners in our Company and Commercial Departments:

Michael Hatchwell
020 7468 2647
mhatchwell@davenportlyons.com

Alon Domb
020 7468 2684
adomb@davenportlyons.com

Robert Charlton
020 7468 2671
rcharlton@davenportlyons.com

Rebecca Ferguson
020 7468 2622
rferguson@davenportlyons.com

Jeanette Gregson
020 7468 2701
jgregson@davenportlyons.com

Jonathan Lass
020 7468 1534
jlass@davenportlyons.com

David Marchese
020 7468 2646
dmarchese@davenportlyons.com

Brian Miller
020 7468 2741
bmiller@davenportlyons.com

Contribution from the Employment Department

John Hayes
020 7468 2728
jhayes@davenportlyons.com

Contribution from the Tax Department

Emma Lampier
020 7468 1528
elampier@davenportlyons.com

trust at any time over that period. The new settlers and trustees have until 6th April 2008 to review these and use such trust powers as they may have to change their trust provisions before the charges apply.

Existing life interest trusts will continue under the pre-budget rules until the current life tenant's interest ends. On the death of the life tenant his estate for inheritance tax purposes will continue to comprise not only the property he owned in the ordinary way, but also the capital of the life interest trust. Thereafter, if the property remains in trust the relevant property rules may apply.

New lifetime trusts

Trusts created during the lifetime of the settlor will now be relevant property trusts (except for those created for a disabled person).

New trusts created by Wills on death

A similar position applies to trusts set up on death, except for those created within very strict conditions, broadly:-

- Trusts set up by a parent for a minor child who will become absolutely entitled at 18, with the special inheritance tax exit provisions applying if the trust continues up to the child's 25th birthday (the 'age 18-to-25' provisions). These will be known as bereaved minor trusts.
- Trusts set up for the benefit of a life tenant with the trust capital vesting absolutely when the life tenant dies or passing into a trust for bereaved minors. A trust of this type for a UK domiciled spouse/civil partner with remainder passing on to minor children at 18 or up to age 25, or on to named beneficiaries absolutely, will continue to enjoy exemption from inheritance tax if it is drafted to fall within the new rules. The recent further changes to the proposed legislation have relaxed the strict curtailment of the spouse/civil partner exemption that had been introduced.
- Trusts set up for a disabled person.

What should you do now?

The Finance Bill is currently being debated and changes have already been made. You will appreciate that this article is only a summary of the new rules and we would urge clients to review their wills, which may incorporate trusts, and to review any existing trusts. The way forward will become clearer after Royal Assent, which is expected mid-July.

Davenport Lyons
30 Old Burlington Street
London W1S 3NL
Tel: 020 7468 2600
Fax: 020 7437 8216
Web: www.davenportlyons.com