Davenport Lyons

Business Law Update

Summer 2004

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DTI Consultation on Directors' and Auditors' Liability - Update

The revised Combined Code on Corporate Governance ("new Code") was published in July 2003 and came into force for reporting periods beginning on or after 1 November 2003. Since its publication the issue of corporate governance has remained very much in the spotlight. Announcements of financial irregularities at companies have been swiftly followed by an analysis of their corporate governance procedures, numerous articles have been written about the dual board structure at Royal Dutch/Shell and more than one director of a publicly listed company has been hauled over the coals at a general meeting over his remuneration package, as institutional investors have increased their demands for better compliance with corporate governance regulations.

The indications are that the corporate governance and compliance regulations are going to get tougher in the future with several new pieces of legislation in the pipeline.

Against this background there is increasing concern by directors and auditors about their potential liabilities. Proceedings have been brought against the directors of Equitable Life and the accountants have been in the firing line with both Deloitte and Grant Thornton having been criticised recently for their role in the Parmalat crisis.

One of the aims of Derek Higgs in drafting the new Code was to improve the quality of non-executive directors and to expand the range of backgrounds from which they are selected. There is a view that the increasing liabilities of directors and the extension of the role of the non-executive director have deterred qualified individuals from accepting positions and therefore defeat this key objective. Similarly some of the accountancy firms believe that the unlimited liability of auditors is making the statutory audit business unattractive.

The DTI consultation paper on directors' and auditors' liability published in December 2003 and summarised in the Winter 2003 edition of Business Law Update sets out various options for the reform of the current law. In publishing the consultation, the DTI was seeking to ensure that a high quality and diverse pool of entrepreneurial people continue to come forward to serve as directors, whilst enabling companies

to hold negligent directors to account. In relation to auditors the key objective is to have high quality independent audits within an open, transparent and competitive market.

The consultation paper has produced a range of reactions, particularly as to auditors' liability, which the DTI is currently considering. The major accountancy firms are in favour of a change in the law to enable them to limit their liability and have warned that without reform of auditor liability another of the accountancy giants could disappear as a result of rising claims and settlements, lack of insurance cover and the restricted amount of capital available. The contrary view is that liability should not be limited as unlimited liability for auditors "concentrates the mind".

One of the DTI's concerns is the impact of competition on the audit market. With this in mind it was announced on 6 July 2004 that the OFT would undertake a 3 week independent review on whether a negotiated cap on auditors' liability would significantly affect competition in the UK market. The OFT has until the end of July to complete its inquiry.

If the DTI concludes that the current law on directors' and auditors' liabilities is reducing both the pool of potential non-executives and competition in the audit market, we may well see the introduction of new legislation. With litigation becoming more commonplace and the extent of legislation and pressure for companies to have rigorous rules and procedures in place increasing, the results of the DTI's consultation will make very interesting reading.

Changes In The Markets

AIM Relinquishes its EU Regulated Market Status, and The London Stock Exchange revises its Admission and Disclosure Standards

New status for AIM

The London Stock Exchange has confirmed that it will change AIM's regulatory status ahead of the deadlines for implementing the EU Directives which form part of the Financial Services Action Plan. From 12 October 2004, AIM will operate as an exchange-regulated market, relinquishing its EU 'Regulated Market' status, which it has held since its launch in June 1995. This move will ensure that AIM's current regulatory regime and market structure will be preserved with continued regulatory oversight by the FSA.

This decision by the London Stock Exchange follows several months of consultation and discussions with the AIM Community, HM Treasury and the FSA about the impact of the EU Directives on AIM. There has been much concern about the additional requirements which would have been imposed on it under the new EU Directives had it stayed as a regulated market. For example, under the Prospectus Directive, AIM companies would have been required to issue a prospectus every time they wanted to issue securities. The London Stock Exchange is now considering specific rule changes that may be required to ensure the continuing smooth operation of AIM as an exchange-regulated market and will be consulting with market participants and the AIM community in the coming months.

Revised Admission and Disclosure requirements

Meanwhile, the London Stock Exchange has revised its Admission and Disclosure Standards with effect from 1 April 2004. These standards prescribe the admission requirements and continuing obligations for companies seeking admission, or already admitted, to trading on the Exchange's markets for listed securities. The main changes to the standards include:

- Form 1 (application for admission of securities to trading) and Form 2 (new issues form) have been merged and revised;
- for new applicants, the requirement to have a meeting with the Exchange has been removed. However, Form 1 must be submitted ten business days prior to admission rather than the current two days; and
- payment of the admission fee is now post-admission rather than pre-admission.

The New Competition Regime

As of 1 May 2004 the competition regime, both in the EU and the UK, has taken on a very different shape and form. The EU's modernised regime has taken effect, devolving responsibility for enforcing competition law from the European Commission to national competition authorities ('NCAs') and courts in the EU member states. This article looks briefly at the main changes in UK competition law as a result of the modernisation at the EU level, and some of the major implications of the new regime.

Main Changes

- The exclusion for vertical agreements under the Competition Act 1998 (the 'Act') has been removed, although there will be a transitional period for vertical agreements lasting until 1 May 2005.

- The system for notifying agreements for clearance under the Act has also been removed - this follows the removal of the notification system at EU level.

- The OFT has been given the power to issue non-binding written opinions in cases which present novel or unresolved questions of law under the Act or Articles 81 and 82.

- The OFT has been given the power to seal premises in relation to investigations under the Act or Articles 81 and 82. The European Commission has also acquired this power under the modernisation regulation.

- The maximum penalty that the OFT can impose for an infringement of either the Act prohibitions or Articles 81 and 82 will be a fine of 10% of the undertaking's worldwide turnover for the year preceding the date of the infringement decision - previously the figure related to UK turnover;

- The OFT has been given a formal power to accept binding commitments from an undertaking to meet concerns over a breach of either the Act or Articles 81 and 82. The European Commission will also have this power under the modernisation regulation.

- Agreements given clearance under Section 21(2) of the old Restrictive Trade Practices Act will no longer be excluded from the Act as from 1 May 2007.

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Implications for vertical agreements

Parties to vertical agreements (i.e. agreements made between two or more businesses that operate at different levels of the production and distribution chain) in the UK will now no longer be able to rely on the UK exclusion and will instead need to satisfy themselves that either they are able to benefit from a 'parallel' EC exemption from the Chapter I Prohibition, or that their agreement does not give rise to an appreciable restriction of competition. Basically, the principle underlying the EC Block Exemption is that vertical agreements will be presumed legal in the absence of market power - essentially where the parties to an agreement have a market share of less than 30 per cent. Below this market threshold, the Block Exemption will apply in principle unless the modification contains any of the 'hardcore' restrictions, such as resale price maintenance.

The significance of the repeal is that all UK vertical agreements will now need to be assessed in the light of the EC rules, whether or not they have the potential to affect trade between EU Member States (and therefore fall within Article 81). Existing UK agreements which have to date relied on falling within the more generous UK exclusion will need to be reassessed for their compatibility with the EC Block Exemption.

Abolition of the advanced notification procedure

Companies will no longer be able to seek a legally binding decision - either negative clearance or exemption - in respect of an agreement. Companies will therefore have to form their own view on whether an agreement is compliant with the Act and would survive an attack by the regulator or other third party during the life of the arrangements or even after they are concluded. This means an increased risk in relation to agreements containing restrictions which fall within the Chapter I Prohibition.

Help is at hand

Before you despair of getting to grips with the new regime, the OFT has published for consultation a draft guidance note on how the modernisation regime will be applied in the UK, an amended version of its rules and 14 Competition Act guidance notes - amended to take into account the effects of the modernisation. The OFT intends to finalise these revised documents by August 2004.

Department Of Trade and Industry, Small Business Service Consultation:

Common Commencement Dates

The DTI Small Business Service has issued a consultation on the desirability of extending, to other areas of law, the existing pilot scheme for Common Commencement Dates. Under the pilot, domestic employment regulations are implemented on two fixed calendar dates (6 April and 1 October) with government publication of an annual statement of forthcoming regulations designed to ease the burden of monitoring change.

The present consultation is addressed to small and medium size businesses, their representatives and other interested parties. It stems from the government's ambition to make the UK 'the best place in the world to start and grow a business' (see DTI's 'Action Plan for Small Business' URN 03/1592, 8 January 2004) and aims to identify (i) which areas of law might be appropriate; (ii) the potential benefits and burdens to business of implementing the scheme; (iii) dates of least inconvenience and the optimum number of implementation dates per year.

Industry-specific regulation from both central and local government is considered as well as generic areas of law such as health & safety, consumer safety, tax and environment. Comment is also invited on how the government might improve other ways it communicates to business about changes in the law. There is interest in seeking further support for the scheme in Europe with regard to internationally applicable regulation.

Consultation was issued on 30 April 2004 and the deadline for responding is 3 September 2004. The government will provide feedback on www.sbs.gov.uk within three months of the deadline.

Liquidation Expenses

The House of Lords has recently made a decision of fundamental importance to lenders with floating charges. In Re Leyland DAF (Buchler & another v Talbot & another (2004)) the House of Lords held that the general costs and expenses of a winding-up are not payable out of floating charge realisations in priority to the claims of the floating charge-holder.

By way of brief background, if a company is not in liquidation and a receiver is appointed, preferential debts are to be paid out of floating charge assets by the receiver in priority to the claims of the floating charge-holder. A similar regime applies where a debenture-holder takes possession of property comprised in a floating charge. Where a company is in liquidation, preferential debts are payable out of the free assets of the company after the expenses of the winding-up. However, if the company's free assets are insufficient to meet the preferential debts, they are to be paid out of the floating charge assets in priority to the claims of the floating charge holders.

In the Leyland DAF case, the Court of Appeal had followed the Barleycorn case (re Barleycorn Enterprises Ltd, Mathias and Davies (A Firm) v Down (1970)) and held that, as liquidation expenses are payable in priority to preferential claims, those expenses must be payable out of floating charge realisations ahead of both preferential creditors and the floating charge-holder if there are insufficient free assets to meet those expenses. It is worth noting that the Barleycorn case had been a surprise too many.

However, the House of Lords held that Barleycorn was a 'complete muddle', and overruled the decision. They reasoned that it was a question of property, not priorities. There are two distinct funds that belong to different parties: proceeds of the assets subject to a floating charge - these belong to the floating charge holder (to the extent of the secured debt) and are administered by the receiver; and proceeds of the 'free' assets - these belong to the company and are administered by the liquidator in the winding up. They would include any surplus from the proceeds of the floating charge assets. Each fund must bear its own costs: the liquidator cannot run his liquidation at the expense of the secured floating charge-holder. Although a lender's floating charge fund remains available to meet the preferential debts, it is not to be depleted by the liquidator's general expenses which have no connection with those preferential debts and would be uncapped.

Although recent changes in legislation have meant that there will be more enforcement of security through the mechanism of administration rather than through the appointment of an administrative receiver, the decision in

Leyland DAF will be extremely important to lenders in all those situations where they will continue to be able to appoint administrative receivers. This will include all floating charges entered into before 15 September 2003 and the important exemptions for certain capital market issues and securitisations, project financings and public-private partnership and utility projects.

Update on Commercial Agents

Many businesses use a variety of commercial relationships in order to acquire the services that they need, as an alternative to taking on employees to do the job for them. Examples range from the supply of cleaning services for business premises, to marketing and even legal services. Frequently, a particular part of a business process can in theory be carried out in a number of different ways, and sometimes the choice that is made can have significant legal implications.

For businesses involved in the manufacture or sale of goods, the basic choice in terms of methods of sale is either to have your own sales force, or appoint a sales agent or distributor. Having your own sales force obviously entails consequences in terms of employment law, and there will be an inbuilt cost which the supplier may or may not be willing to undertake.

In theory, at any rate, appointing a distributor or agent may be a more efficient and economical method of getting your products to a particular market place. Sometimes the distinction between agency and distribution can get blurred, but it is advisable to get things clear on this, because the route you take will have different consequences in terms of risk in the selling process, and also the costs of the sales operations.

With a distribution agreement, the supplier sells goods to the distributor, who then takes over the risk of reselling them, but also the opportunity to make a profit on the sale to the end customer. With an agency relationship, at least one of the "classical" type, sales are made on behalf of the supplier, who therefore retains direct responsibility for the sale to the end customer, as well as control.

However, one important area that needs to be considered in the case of a commercial agency is whether there will be a potential cost in terms of compensation that may be payable to the agent on termination of the agency arrangements.

The reason for this is that in 1993 the UK adopted Regulations implementing a EU Directive on commercial agents that had first been passed in 1986. This was intended to protect the rights of self-employed commercial agents. In many ways the protection offered is similar to that enjoyed by employees. In particular, there are restrictions on the ability of a supplier to terminate the position of a commercial agent, and on termination either compensation or an indemnity may be payable, in addition to commission earned in the course of the agency relationship.

The Directive and the UK Regulations do not just apply to individuals, they also apply to companies acting as commercial agents, and the compensation or indemnity arises on termination in a number of circumstances, including even the death of the agent. For some time it was unclear whether compensation or an indemnity was payable simply because the commercial agent had a fixed term contract that came to an end. However, in the UK case of Whitehead v Jenks & Cattell Engineering Limited (an unreported case from 2001), it was held that it was payable in such circumstances, and this has recently been confirmed by the Court of Appeal in the case of Stuart Light and Others v Ty Europe Limited (decided in July 2003).

Payment of compensation in these circumstances is not automatic, but can involve significant amounts, so it is not surprising that some suppliers will seek to avoid it altogether. It is not possible to contract out of the Directive or the Regulations, but it is possible to structure a business arrangement so that the Regulations do not apply, for example in the case of a true distribution relationship.

The Regulations only apply if the commercial agent has continuing authority to negotiate the sale or purchase of goods on behalf of the supplier, or to negotiate and conclude such sales or purchases on behalf and in the name of the supplier. This will mean, for example, that a representative who does not have authority to negotiate or conclude sales or purchases, and so is merely carrying out general marketing functions, and referring all sales to his principal, should not be entitled to the protection of the Regulations.

It is also worth mentioning that agents who deal with the distribution of a supplier's services (as opposed to goods) will not be protected by the Regulations. The key point is therefore to be clear what the underlying nature of the commercial arrangement is, and to be aware of the possible costs.

Raising Finance

Are things going to get more relaxed?

One of the areas on which we often advise our clients is how to deal with (and possibly avoid) the prohibition on financial promotion set out in the Financial Services and Markets Act 2000. This is the prohibition on communicating, in the course of a business, an invitation or inducement to engage in investment activity unless the invitation or inducement is either issued by an authorised person, or approved by an authorised person.

There are certain exemptions to the prohibition, one group of which are commonly referred to as the 'business angel exemptions.' These cover promotions to high net worth individuals and sophisticated investors. However, the government has become increasingly concerned about the very limited uptake of these exemptions, and the effect this has on restricting access to funds for small and medium-sized enterprises in particular. The government has therefore launched a consultation on this area, seeking views on the operation of, and possible changes to, the existing exemptions. In particular, the government is seeking views on:

- whether the current exemptions are allowing appropriate numbers of high net worth and sophisticated individuals to become certified and, if not, whether this is posing a problem for smaller firms seeking to raise capital via unlisted equity and for investors;

- whether promotions should be allowed where the person making the promotion has a reasonable belief that the investor is high net worth or sophisticated; and

- whether self-certification should be introduced (with three different models of self-certification being suggested).

Whilst the interests of business are obviously key to this consultation, there has been some disquiet about the effect of any proposed changes on consumers. The Financial Services Consumer Panel has pointed out that any change to self-certification would mean that consumers who define themselves as high net worth and sophisticated investors could invest in unlisted companies without any regulated advice, and so could lose their money without comeback through the Financial Ombudsman Service or Financial Services Compensation Scheme. The Panel feels that the proposal focuses on the demand from business for business angels, without considering the possible risks for consumers. It believes that the possibility of more consumers being mis-sold means that no changes should be made to the current rules on financial promotion in this area.

The results of the consultation will be significant for all companies trying to raise finance - watch this space.

House of Lords confirms injury to feelings no longer recoverable in unfair dismissal claims

The House of Lords has recently unanimously decided in the case of ***Dunnachie v Kingston-upon-Hull City Council 2004*** that damages for injury to feelings are not recoverable in unfair dismissal claims. Employees will consequently no longer be compensated for hurt feelings arising from the manner of their dismissal. Prior to the Court of Appeal decision in the Dunnachie case employees had been awarded up to £25,000 by the Employment Tribunal for the humiliation, distress and damage to their reputation caused by their employer.

The House of Lords held that s.123 of the Employment Rights Act 1996, which governs the position on compensatory awards, only allows Employment Tribunals to award financial losses in unfair dismissal claims such as loss of earnings, benefits or expenses.

This decision overturned that of the Court of Appeal which followed the case of *Johnson v Unisys Limited 2001 AC 518*. In Johnson v Unisys, Lord Hoffman had commented that because a tribunal may award an amount which it "considers just and equitable" under s.123 of the Employment Rights Act 1996, the Applicant's loss was not limited to pecuniary loss. Non-economic loss arising from the manner of the employee's dismissal could therefore be recovered. In that case, the Applicant was consequently awarded £10,000 for injury to feeling in addition to his loss of earnings.

The ***Dunnachie*** decision has reinstated the position that had previously survived for more than 30 years since the decision of National Industrial Relations Court in *Norton Tool Co.Ltd v Tewson 1972 ICR 501.*

The decision will no doubt reduce the levels of awards of unfair dismissal compensation. It does not, however, stop employees from claiming injury to feelings in discrimination cases.

Stressed out?

According to the Health & Safety Executive nearly one in five of the UK workforce report that they feel very stressed or extremely stressed by their work. Since 1995 work-related stress has taken over as the primary reason for sickness absence in the UK and it is estimated to cost UK companies £3.7 billion each year. During 2003 more than 13 million days were lost to stress related illnesses.

What is stress? It has been defined by the Health & Safety Executive as the adverse reaction that some people can have to excessive pressure or other types of demand placed on them. When you are notified that an employee is suffering from stress at work there are four potential legal claims of which you should be aware. These are personal injury, unfair dismissal, disability discrimination and contractual claims.

The first potential claim is that of personal injury. Under section 2 of the Health & Safety at Work Act 1974 it is "the duty of every employer to ensure, so far as is reasonably practicable, the health, safety and welfare at work of its employees". This is a codification of the common law duty of care. To succeed in a personal injury claim an employee needs to prove that the employer has acted negligently resulting in an injury (whether mental or physical) suffered by an employee. The recent case of *Barber v Somerset County Council* confirmed that only injuries that are reasonably foreseeable will be covered. The test was stated to be "the conduct of the reasonable employer, taking positive thought for the safety of his workers in the light of what he knows or ought to know". Therefore once an employer knows or ought to know that an employee is at risk of suffering injury from work-related stress, they are under a duty to do something about it.

In relation to employees with at least one year's service, to avoid a finding of unfair dismissal an employer must show (a) that it had a fair reason for the dismissal; and (b) that the procedure was fair in all of the circumstances. Under section 98(2) of the Employment Rights Act 1996 "capability" is a potentially fair reason for dismissal. Under section 98(3) "capability" can be assessed by reference to the employee's health. In capability cases a fair procedure will include genuine consultation with the employee, taking medical advice and acting on that advice, consideration of suitable alternative positions prior to dismissal and implementation of a right of appeal.

Under the Disability Discrimination Act 1995 employers cannot discriminate against employees with a long-term physical or mental impairment that has a substantial and adverse effect on an employee's ability to carry out day to day activities unless such treatment can be justified objectively. The DDA also imposes a duty to consider reasonable adjustments that could put an employee on a "level-playing field" with non-disabled employees. A failure to make reasonable adjustments can be justified. Stress will only amount to a disability if it leads to a "clinically well-recognised condition" as specifically mentioned in the World Health Organisation's International Classification of Diseases or recognised by some other classification or respected body of medical opinion.

What should an employer do when faced with a potential stress claim?

The contractual claims are primarily constructive dismissal cases where an employee alleges that the employer has committed a fundamental breach of the contract of employment, entitling the employee to resign. Contractual claims of up to £25,000 can be brought in a Tribunal or for larger amounts in the High or County Court.

In view of the growth of stress as an issue the Health & Safety Executive has set out management standards relating to six elements of jobs that are linked to ill health. These are Demands, Control, Support, Role, Relationships and Change. The standards are intended to provide a yardstick against which organisations can measure their progress in tackling work-related stress. They are basically a stress test. So far they are only guidance not law.

People react in different ways to stress - many may reject help. People who have coped with stress for many years can suddenly stop coping (often as a result of a catalyst in personal life). Managers make incorrect assumptions often concluding (wrongly) that stress is not genuine. But against that, it cannot be denied that many employees allege stress when they are not genuinely ill.

So what should an employer do when faced with a potential stress claim? First, don't make assumptions. Employers are not usually medically trained and should act sympathetically bearing in mind the potential legal implications. Affected employees should be consulted and medical advice taken at an early stage and abided by. A return to work plan should be agreed considering reasonable adjustments such as a phased return to work, changes to hours and/or role.

TUPE - can it apply where a single economic entity becomes two distinct entities?

According to a recent case, the answer is yes. The Court of Appeal has held that it does not automatically follow that the Transfer of Undertakings (Protection of Employment) Regulations 1981 ('TUPE') cannot apply where an undertaking which was operated as a single economic entity before the date of a transfer is subsequently operated as two distinct entities after the transfer.

By way of brief background, TUPE applies to a transfer of an undertaking or a part of an undertaking. The undertaking or part must be a stable economic entity which retains its identity after the transfer (the Suzen case). In the case of Fairhurst Ward Abbots Ltd v Botes Building Limited (2004) a borough was split by the council into two distinct geographical parts, areas one and two. B had been providing services to the council under a framework agreement covering the whole borough. After the split, F won the tender for area two. There was no transfer of assets from B to F and F refused to take on any of the employees who had been working in what had now become area two. Some employees brought unfair dismissal claims against B when it refused to continue to employ them. B argued that there had been a TUPE transfer, so that F was responsible for the unfair dismissal liability. F denied that there had been a TUPE transfer.

The employment tribunal and the Employment Appeal Tribunal both held that there had been a TUPE transfer and so liability for the dismissals had transferred to F. The Court of Appeal upheld the Tribunal's decisions and found that there had been a TUPE transfer. The court rejected F's argument that, since area two did not exist as a distinct economic entity before the TUPE transfer, it could not be said that that an economic entity had retained its identity after the transfer. TUPE applies to the transfer of both an undertaking and part of an undertaking. On the facts, area two was a distinct part of an undertaking and was sufficient to be an economic entity.

TUPE is always an area in which great care must be taken, and this case highlights quite how far-reaching the legislation can be.

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.

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