



Business Law Update

Winter 2004

The new rules on directors' liability

Following on our discussion on this topic in previous editions of Business Law Update, legislation has now been enacted and new rules have been introduced regarding directors' liability. The Companies (Audit, Investigations and Community Enterprise) Act 2004 (the 'Act') also deals with auditors' liability (where it has been decided not to introduce a cap on auditors' liability, much to the concern of many accountancy firms), however in this article we will focus on the position with respect to directors' liability.

Under the common law directors face real exposure to personal liability from the nature of their role and the accompanying responsibilities. As you will be aware, in the wake of corporate scandals such as Enron and Worldcom, much emphasis has been placed on tightening up corporate governance. However, the government has been concerned to balance this with the need to ensure that becoming a director (particularly a non-executive director) is still an attractive option, and that companies are able to attract high-calibre individuals.

The government has decided not to permit companies to cap or limit the liability of directors, as is allowed in the US (and as was mooted by, for example, the CBI). However, it has decided to relax the prohibition on companies indemnifying their directors against costs and liabilities. At present, under Section 310 of the Companies Act 1985, a company may not generally exempt its officers (or its auditors) from, or indemnify them against, liability for any negligence, default, breach of duty or

breach of trust in relation to the company. However, the Act will now allow companies:

- (i) to indemnify directors in respect of proceedings brought by third parties (covering both legal costs and the financial costs of any adverse judgment, except for the legal costs of unsuccessful defence of criminal proceedings, fines imposed in criminal proceedings and penalties imposed by regulatory bodies such as the FSA); and
- (ii) to pay directors' defence costs as they are incurred, even if the action is brought by the company itself (although the director would still be liable to pay any damages awarded to the company and to repay his defence costs to the company if his defence was unsuccessful).

Note that companies that choose to indemnify directors will have to disclose such indemnities in the directors' report and provide shareholders with the right to inspect

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any indemnification agreement. In addition, amendments are likely to be required to most company's **articles of association** (which will typically be framed around the existing Section 310 Companies Act 1985), and **these should be reviewed if directors wish to be fully protected.**

The proposed new powers, expected to come into force in April of next year, are, at least, a relaxation of a restrictive area of company law. Companies will, however, need to consider carefully how to utilise the new

provisions and consider under what circumstances they agree to indemnify or pay the costs of directors. The DTI believes the measures will help improve the quality of governance in boardrooms. Some commentators have, however, queried whether the government has actually gone far enough to persuade more people to become non-executive directors. Only time will tell.

Registration of charges and other security interests

We know that many clients (and many lawyers!) find the current system of registration at Companies House of security interests cumbersome, confusing, expensive and arbitrary, with the rules of priority being complex and unclear. Proposals are currently being considered which, if implemented, would represent a dramatic shake-up of the system.

The idea behind the proposals is to replace the current registration scheme set out in the Companies Act 1985 with a more comprehensive legislative scheme which would:

- introduce a notice-filing registration system (that would be wholly electronic), so that both registration (filing) and searching could be carried out via the Internet or direct computer link. Companies would no longer be legally responsible for registering charges - filing would be up to the secured party;
- eliminate the need to register twice in relation to property for which there is a specialist mortgage register (such as ships, aircraft and certain intellectual property rights);
- remove the 21-day time limit for registration and any need for a court order for late registration;
- enable filing before the security agreement is finalised (provided both parties agree), to protect the lender's priority position. A single filing would be possible in relation to a series of transactions between the same parties;
- enable fast, cheap searching. Charges would appear on the register the moment a filing has been made, virtually eliminating periods of invisibility after a charge has been created but before it has been registered;

- set out clear rules on priority, which would broadly observe the existing balance between competing security interests, but linking priority to facts that could be readily determined, such as the date of registration. Once the secured party had filed, it could be confident that its security would have priority as against any other secured party from the date of filing, save in those specific cases in which the scheme provides otherwise;
- remove the distinction between fixed and floating charges: in effect the floating charge would be replaced by a new form of security interest that has the same advantages for lender and borrower but with fewer disadvantages to the lender; and
- set out clear rules to identify when a person who buys property from a company would be bound by, or would take free of, any security interest over that property. Basically a buyer or lessee of an unperfected security interest without knowledge of the security interest would take free of it. A buyer or lessee of goods of a kind that the seller sells on a regular basis would take free of any security interest created over the goods by the seller, unless the buyer had actual knowledge that the sale was in breach of the security interest.

The Law Commission (who published the proposals) claims that the proposals offer clear priority rules for competing charges that fit modern methods of business finance. Taking advantage of the ease and low cost of electronic registration, they also propose that the system is used to give information about transactions that are not currently registrable as 'charges' but that fulfil a very similar economic function, for example: sales of debts due to the company ('receivables'); and 'title-financing' such as conditional sales, hire-purchase and finance leases, with appropriate priority rules to protect the financier. If accepted, the scheme could be extended to cover security granted over the assets of unincorporated businesses as well as companies.

The Law Commission plans to amend the draft regulations and publish a final report by the summer of 2005. The report should set out its final recommendations on a scheme for security interests created by companies and, depending on the results of the consultation, address the question of extending the scheme to non-corporate business, as well as possibly also making recommendations on security interests created by consumers. It is expected that the draft regulations will be incorporated in a future DTI Companies Bill.

The new European company is finally a reality

So the new European company is finally a reality (45 years after it was first proposed), but how useful will it be in practice?

- It will be known as the Societas Europaea, or SE, and will resemble a public limited company. The European law responsible for implementing the new SE applies across the EU, and so the vehicle will, in theory, be available to businesses in every member state. There is an important condition though: the SE will have to be genuinely cross-border. Either the shareholders have to be from at least two European countries, or there has to be a merger of companies from at least two countries, or an existing company that wants to convert to an SE must have had a subsidiary in another member state for at least two years.
- The main aim of establishing the SE was to enable it to operate in all the Member States and be subject to only one set of rules, rather than having to have separate corporate entities observing different rules within each Member State. However, there is concern that whilst the SE will go some way towards introducing a common 'European' company, it will still be a company incorporated in a particular Member State rather than at European level and there will be differences in the treatment of SEs from one Member State to another. Although there are a few advantages of the new vehicle, for example an ability to transfer the registered office to other EU countries without significant formality, the main attraction of the SE is likely to be symbolic. Companies who want to show that they are truly European, and not located in any particular company, might feel that the new form is a useful way of doing so.

Essential characteristics

Whichever Member State an SE is registered in, there are certain fundamental characteristics of all SEs:

- a public (not private) limited liability company;
- capital divided into shares;
- a separate legal personality;
- minimum subscribed capital of €120,000; and
- a registered office and head office in one of the Member States (which must be the same Member State and may, at the option of the Member State, be required to be at the same address).

Formation of SEs

There are a number of ways to form an SE. The following requirements must be met, regardless of the method of formation used:

- there must be two or more commercial bodies involved, at least two of which must be resident in different Member States;
- generally the companies participating in the formation of an SE must have their registered and head offices within the Community, though there is an option in the SE Regulations for Member States to allow other companies sufficiently connected with the Member State to participate in the formation of an SE; and
- the question of employee involvement must have been addressed before the SE can be registered.

The methods of forming SEs are:

- **Formation by merger** - public limited liability companies formed under the laws of a Member State with their registered and head offices within the Community may form an SE by merger (either by acquisition (where the acquiring company becomes an SE) or by formation of a new company (where the newly formed company is an SE)), provided that the participants comprise at least two companies governed by the laws of different Member States.
- **Formation of a holding company** - public or private limited liability companies formed under the law of a Member State with their registered and head offices within the Community may form a holding SE provided that each of at least two of these companies is governed by the law of a different Member State or for at least two years has had a subsidiary governed by the law of another Member State or a branch situated in another Member State.
- **Formation of a subsidiary company** - companies, firms and other legal bodies governed by public and private law formed under the laws of a Member State with their registered and head offices within the Community may form a subsidiary SE provided that each of at least two of these companies is governed by the law of a different Member State or for a period of two years has had a subsidiary governed by the laws of another Member State or a branch situated in another Member State.
- **Conversion by a plc** - a public limited liability company formed under the laws of a Member State with its registered and head offices in the Community can be

transformed into an SE provided that it has had a subsidiary governed by the laws of another Member State for at least two years.

- In addition, an SE may set up subsidiaries in the form of SEs.

From a UK perspective, the main 'problem' areas are: (i) the concept of two-tier boards, and (ii) employee-related issues. In the case of the former, the EU legislation envisages that SEs may be formed with either a one-tier or two-tier board structure and the freedom of choice lies with the companies forming the SE: it is not for Member States to decide whether or not both systems should be available. Where there is no provision under the national laws for either the one-tier or two-tier structure, the EU legislation states that the Member State may adopt appropriate provisions. The DTI has stated that nothing in UK law currently prevents public limited companies

incorporated in the UK from adopting a structure under their articles whereby the powers granted to the directors are divided between two tiers of directors. Accordingly the DTI has proposed to rely on the flexibility of UK company law rather than make special legislative provision for two-tier boards. With respect to the second issue, there are two principal employee-related issues: the extent to which the EU Directive creates new, or impacts on existing, obligations to inform and consult with employee representatives; and the right on the part of employee representatives to participate in the management of SEs, for example, by attending board meetings - rights which do not currently exist in the UK.

Those seeking further information on this new vehicle should get in touch with their usual contact at DL or one of the partners listed at the end of this publication.

Fellow directors- can you rely on their expertise?

Where one director of a company has expertise in a particular area - for example a finance director's expertise in preparation of accounts - it is often tempting for the other directors to defer to the expert. But what risks might they be exposed to if they do so?

The recent disqualification proceedings in *Re Queens Moat Houses plc (the "Company")*, *Secretary of State for Trade and Industry v Bairstow* [2004] offer guidance for directors wondering whether they can safely rely on other directors.

The Company's shares were suspended in 1993 and DTI inspectors found that the company had published false and misleading financial results, with the result that the stock market had been misled.

Mr Bairstow was the Company's chairman and managing director. By the time the proceedings against Mr Bairstow came to trial three other directors had already been disqualified.

Mr Bairstow's defence to the case that (whilst he had not acted dishonestly) his failure to recognise that the accounts were misleading amounted to gross negligence was that, lacking accounting expertise, he was entitled to rely on his finance director to produce accurate statements.

The decision of the Judge in the companies court underlined the duty imposed on directors in delegating

their authority to supervise those delegated functions. The extent of the duty to supervise does, however, depend on the circumstances of the case in question. On the facts of this case the court found that the defendant could not reasonably be held to have been under a duty to question the draft financial statements produced by the board, save to the extent that they contained matters which should have been apparent to someone of his experience and understanding of the company's affairs as being of at least doubtful accuracy. The defendant did not, however, have a duty to check that those functions delegated to the finance director, which were properly within the specific expertise of an accountant, were being correctly performed.

The misstatements in question in this case included the amount and type of profits made by the company - not only would the defendant not have to be a qualified accountant to know that those figures were inaccurate; but given his business experience, knowledge of the company and role as managing director - his failure to recognise the inaccuracies was sufficient to satisfy the court of his negligence. He was disqualified for six years.

In essence, then, to successfully employ a defence to disqualification proceedings based on reliance on other directors, an honest director would have to demonstrate that:

- he had fulfilled his duty to supervise properly a delegated function; and
- that he had only relied on the expertise/experience

of another director where the delegated function was not one that was within the scope of his expertise or knowledge.

In practical terms, such a 'defence' is clearly likely to be of limited application. The message for directors seeking to rely on others is to proceed with caution.

AIM: recent developments

Revisions to the AIM Rules

A revised version of the AIM Rules was published in October, making the following amendments:

- **Reverse takeovers (Rule 13)** - the definition of 'reverse takeover' has been amended, in the case of an investing company where no admission document was produced on admission, to include acquisition or acquisitions in a twelve month period which would depart substantially from the investment strategy stated in the company's pre-admission announcement;
- **Disclosure of miscellaneous information (Rule 15)** - an AIM company must announce any change in its legal name;
- **Half yearly reports (Rule 16)** - as previously proposed, Rule 16 has been amended to provide that the information contained in a half-yearly report must include at least a balance sheet, income statement and cash flow statement and must contain comparative figures for the corresponding period in the preceding financial year. The report must also be presented and prepared in a form consistent with that which will be adopted in the company's annual accounts, having regard to the applicable accounting standards. Where the half-yearly report has been audited it must contain a statement to this effect;
- **Restriction on deals (Rule 19)** - restrictions on dealings during a close period have now been extended to 'treasury shares';
- **Information to the Exchange (Schedule 1)** - applicants to AIM that are already quoted on an AIM-designated market such as NASDAQ or the Official List must now produce audited interim accounts if their latest published report and accounts relate to a period ended more than 9 months prior to admission;
- **Guidance Notes** - under the notes to Rules 1 (Nominated adviser) and 32 (Retention of nominated advisers) an AIM company is now permitted to retain

the services of only one nominated adviser at any time; the notes to Rule 27 (Applications for further issues) have been amended to restrict the circumstances in which block admissions may be used; and the notes to Rule 29 (Directors' responsibility for compliance) provide that an AIM company must ensure that it has in place sufficient procedures, resources and controls to ensure compliance with these rules.

The updated rules (both clean and marked versions) are available on the AIM section of the London Stock Exchange's website at www.londonstockexchange.com/en-gb/products/companyservices/ourmarkets/AIM.

Proposals under consideration

It is reported that further changes to the rules governing admission to AIM are being considered in an attempt to strengthen the reputation of the market. Proposed new criteria include the introduction of a minimum trading record; a minimum proportion of shares to be held in public hands; and indices of AIM companies by size and sector (along the lines of the FTSE).

Such changes, if implemented, would represent a significant departure from the relatively light regulatory touch that AIM companies have enjoyed so far. The reason why such changes are being mooted relates to the perception that some companies are seeking to join AIM without having reached the required standard or maturity. It would only take one or two 'high profile' disasters to indelibly damage AIM's reputation. John Pierce, head of the Quoted Companies Alliance, stated: 'The plans the exchange are looking at sound very sensible.' Another (unnamed) insider stated: 'there is some concern that there are companies coming to the market, particularly with overseas companies, with very little trading background. We need to ensure the quality of the market is maintained.'

New Accounting Regime

1 January 2005 is one of those dates for accountants and companies that has been looming in the distance, and is now becoming ominously close.

For accounting periods commencing on or after 1 January 2005, the consolidated financial statements of UK companies and building societies with securities traded on an EU regulated market must be prepared under EU adopted International Financial Reporting Standards (IFRSs). Other companies will be able to continue to prepare their financial statements in accordance with UK accounting standards but may opt to use IFRSs. At the same time as IFRSs are introduced, changes will also be made to UK law arising from the European Fair Value Directive and the Modernisation Directive.

Much as the requirement to implement the new standards relates only to (in general) 'listed' companies, all companies could be affected. Not only will it be sensible for those companies aiming to list in the near future to adopt the new standards, but the draft regulations which have been laid before Parliament to implement the provisions of the Accounts Modernisation and Fair Value Directives for companies also contain proposals to allow

all companies (and building societies) to use the international accounting standards from 1 January 2005.

The Institute of Chartered Accountants in England and Wales (ICAEW) has published new guidance to assist auditors in assessing and commenting on the state of their clients' readiness for the transition to International Financial Reporting Standards ('IFRS') and to prepare for the auditing implications. Unfortunately, recent research indicates that a large number of companies to which IFRS will apply will not be prepared for the deadline.

In announcing publication of the new guidance, the ICAEW warns that companies need to carry out comprehensive analysis of their transactions and exposures and must understand the major changes which will impact on format of accounts, formulation of accounting policies and compliance with more extensive disclosure requirements. Companies and auditors need to be prepared for some hard work ahead.

Small Firms Loan Guarantee

Some of you may recall that the 2003 Pre-Budget Report announced that the Chancellor and Secretary of State for Trade and Industry had asked Teresa Graham OBE of Baker Tilly to lead an independent review of the Small Firms Loan Guarantee (SFLG). The SFLG guarantees loans from banks and other financial institutions for small firms that have viable business proposals but who have tried and failed to get a conventional loan because of lack of security.

The review was asked to work closely with the main SFLG lenders and to examine, and if appropriate, make recommendations regarding: the structure and rules of SFLG and their appropriateness to the scheme's effective operation; and whether SFLG, as the Government's principal intervention in the supply of

debt finance to SMEs, is effective in tackling the barriers faced by start-ups and small businesses in the current market.

The final report has now been published, and the government announced on 4 October that it would accept the recommendations in full. The proposals include an expansion of the levels of funding available to individual SME's; raising the turnover limit for eligible SME's; focusing the scheme on supporting high growth start ups and young firms by introducing an age limit on eligible firms; and a reduction in the bureaucracy surrounding SLFG. Further details can be obtained from HM Treasury's website at www.hm-treasury.gov.uk.

New Tax and Retirement Rules Affecting Inheritance Tax Planning



By: Andrew Kemp, an independent financial adviser with IFPC Ltd

On 6 April 2006 ("A-Day") the provisions of the 2004 Finance Act simplifying all new and existing pension plans, are to take effect. These changes seek to standardise all pension plans and are extremely significant.

The introduction of a maximum lifetime allowance (the "MLA"), initially £1.5m per person rising to £1.8m by 2010 could cause difficulties for many companies operating pension schemes, in particular those having a final salary scheme which has accrued a fund for any individual in excess of the allowance. Amounts held in excess of the MLA will be subject to a new recovery charge (subject to tax up to 55%) which would diminish such a fund (conceivably in breach of such company's final salary obligation).

On the other hand, the new legislation provides great opportunities to:

- everyone, by holding assets in a pension fund (including assets which were previously prevented from being so held, such as your own residential property) such assets would be exempt from inheritance and capital gains tax whilst having the potential of minimising income tax liability; by the removal of the requirement to buy an annuity and the opportunity of putting existing personal pensions into trust to minimise the tax liability

of beneficiaries. The removal of the restriction on residential property is particularly interesting. Could it create another "property boom" after A-Day?;

- employers to incentivise key staff by contributing significant amounts to an individual's pension fund instead of by way of salary to help maximise the fund. This may be of particular interest to older workers who can afford a "salary sacrifice". Whereas current employee contributions are limited to a percentage of earnings, the new rules are not so limited (subject to a maximum cap on the total tax relieved of initially £215,000 rising to £255,000 by 2010);
- business owners, from A-Day, a company shareholding (even where an individual shareholder is considered a "connected person") may now also be held in a pension fund and therefore exempt from inheritance and capital gains tax (together with scope for minimising income tax liability). There may also be more tax efficient exit strategies for retiring business owners, after A-Day which may affect the proposed date of retirement;
- high net worth individuals who could benefit from transitional arrangements protecting high accrued funds (i.e. above the MLA) as at A-Day. It is vital to

review one's circumstances to see if action should be taken prior to A-Day to benefit fully from the transitional arrangements (which may be subject to registration requirements) and to protect the built up funds if they exceed the MLA.

- tax-free cash planning - Look to see if you have any old plans with tax-free cash greater than 25% of the fund. If so make sure they are in the best plan pre - A-Day, otherwise your maximum entitlement could be reduced.

Overall there are still areas which may be amended in further regulations.

An interesting article by Andrew Kemp on this subject is published with kind permission in the Winter 2004 issue of DL Review. The opinions expressed in that article are those of the author and are not necessarily of Davenport Lyons who make no representations as to its accuracy or completeness. The article comprises general information only rather than advice and should not be relied on to make (or refrain from making) any investment, tax, legal or other decision. Should you have any questions regarding your own particular circumstances, please contact Jeffrey Cohen, Davenport Lyons.

Fraudulent filing at Companies House - have you been hit?

Companies House has become increasingly aware over the last few years of fraudulent or irregular filing of documents by individuals trying to commit corporate and/or identity fraud.

The most common complaints relate to circumstances where someone has either:

- changed their company's registered office address without formal consent; or
- changed the directors of the company.

There have also been complaints from people who have, without their prior knowledge or consent, been appointed as officers of a company. The main purpose of these actions is to try and defraud innocent third parties into supplying goods or services or to obtain a good credit rating and thus seek finance from banks and other organisations.

Companies House are taking steps to try and combat this. They conduct basic checks on the forms delivered for registration to ensure that they have been properly completed and signed. Companies House also has a Customer Services department to deal with allegations of fraudulent filings. They also recommend the use of their 'Monitor' service to keep an eye on company records for any unauthorised changes. This 'Monitor' service can be used to provide the company with a copy of any document placed on its record and thus can alert them to any unauthorised filings at an early stage. Looking externally, Companies House advises people to report any such matters to the Police and to the Companies Investigation Branch at the DTI.

Finally, Companies House are also encouraging greater use of their electronic filing service, which offers a more secure method of delivery requiring passwords and authentication codes and are looking to enhance the existing electronic filing service and related services in order to reduce the possibility of irregular or fraudulent filings.

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 Department:

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