UK Corporate Briefing

Issue 6 - Summer 2016

Welcome to the autumn 2016 edition of Dentons' UK Corporate Briefing, a quarterly summary of the most significant recent and forthcoming developments in company law and corporate finance regulation in the UK.

Legislation update

Corporate directors: no ban yet

There has been a further delay to the ban on UK companies appointing corporate directors. There is, as yet, no new firm implementation date.

The Companies Act 2006 currently allows companies to appoint corporate directors as long as at least one director is an individual. As part of the drive to increase corporate transparency, the Small Business, Enterprise and Employment Act 2015 introduced a ban on corporate directors, subject to certain exceptions. The relevant sections were scheduled to come into force in October 2016. However, the Companies House timetable now states that the detail of the exceptions is still under development and that they will announce the implementation date as soon as it is available.

Once the ban on corporate directors comes into effect, there will be a 12-month grace period for existing corporate directors.

Changes to the PSC regime

Although the PSC regime has only been in force since spring 2016, the government is now consulting on changes to the regime to make it compliant with the Fourth Money Laundering Directive.

The Directive came into force on 25 June 2015 and EU member states must implement it by 26 June 2017.

The consultation highlights two areas where the requirements of the Directive and the UK's existing PSC regime differ and where, therefore, changes to the UK regime will be necessary:

- The Directive requires that centrally-held beneficial ownership

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information must be current. In contrast, under the UK's PSC regime companies and LLPs only have to report once a year to Companies House through the confirmation statement. (Companies must keep their own PSC registers up to date, but this is not "centrally-held" information.)

- The Directive covers a broader range of entities including unregistered companies, open-ended investment companies, building and friendly societies, and Scottish limited partnerships.

In July 2016, the Commission published proposals to amend the Fourth Money Laundering Directive, including those parts of it which deal with the disclosure of information about beneficial ownership. These include a proposal to reduce the registration threshold for people with significant control from 25% to 10% for "passive non-financial entities" (i.e. holding structures). There is also a proposal that member states must set up central registers with the beneficial ownership information about trusts and other types of legal arrangements having a structure or function similar to trusts. These amendment proposals remain subject to negotiation by EU member states, as does the European Commission's proposal to bring forward to 1 January 2017 the date by which member states must implement both the Fourth Money Laundering Directive and its proposed amendments.

Consultation on the transposition of the Fourth Money Laundering Directive

Case law update

Warranties and representations distinguished

The High Court has considered whether warranties in a share purchase agreement were also representations and could, therefore, found an action for misrepresentation under the Misrepresentation Act 1967.

Background: A representation is a statement of fact by a person which induces another to enter a contract. If the statement proves to be false, the party who entered the contract in reliance on it may have a claim for misrepresentation and the contract may be voidable. A warranty is a contractual promise. If the warrantor breaches that promise, the other party to the contract may have a claim for breach of contract.

Facts: The claimant bought from the defendant and one of its subsidiaries the entire issued share capital of a company.

The share purchase agreement stated that:

"Each of the Sellers warrants to the Buyer in respect of itself and its Relevant Shares in the terms of the

Warranties in paragraphs 1 and 2 of Schedule 4...on the date of this Agreement."

The agreement defined *the "Warranties" as "the warranties given by (i) [seller 1] in Schedule 4 and Part 2 of Schedule 7; and (ii) [seller 2] in paragraphs 1 and 2 of Schedule 4;".*

The agreement contained several limitations on the sellers' liability for breach of the Warranties. These included one which precluded recovery for a claim under the Warranties if the buyer did not notify its claim within 18 months of completion.

After that time, the buyer, as claimant, sued the sellers alleging that certain of the warranted matters were untrue at the date of the agreement. The buyer accepted that any claim for breach of the Warranties was time barred. Instead, it brought its claim under section 2(1) of the Misrepresentation Act 1967 arguing that a misrepresentation claim was not time barred by the agreement. The misrepresentation claim had two limbs. The first was that the fact that the Warranties were contractual warranties did not derogate from their inherent quality as representations. The second was that by providing the buyer with an execution copy of the agreement, by offering to sign it or by signing it, the sellers had made pre-contractual representations to the buyer.

The sellers made an application for summary judgment to dismiss the buyer's claim arguing that it had no real prospect of success.

Decision: The High Court dismissed the buyer's claim. On the buyer's first argument, the court held if a contract states only that a party gives a warranty, that party does not by concluding the contract make any statement that might found a misrepresentation claim. In so deciding the court followed the earlier High Court decision in *Sycamore Bidco Ltd v. Breslin Ltd.* [2012] EWHC 3443 in which the court also found that whether an express warranty is also an actionable representation is a matter of construction and that clear contractual language is necessary to achieve that result.

On the buyer's second argument, the court accepted that, in principle, it is possible for language used in a negotiating position, or in draft wording passing between the parties during negotiations, to amount to a pre-contractual representation. However, the court decided that it was artificial and wrong in principle to read the Warranties Schedule in the agreement as if it had a pre-contractual existence independent of its function in the execution copy of the agreement which was to provide content to the Warranties. The sellers' action indicated no more than a willingness to give a certain set of contractual warranties in a concluded contract.

Comment: This case reinforces that it is likely to be difficult for a buyer to argue that warranties in a share purchase agreement have effect as representations absent a clear indication that they are to be treated as such.

The case also highlights the importance from a seller's perspective of including a comprehensive entire agreement clause which excludes the seller's liability for any misrepresentation (other than fraudulent misrepresentation). The court found in this case that the entire agreement clause in the agreement between the parties had the effect of excluding the sellers' liability for misrepresentation. So even if it had been successful in its other arguments, the buyer's claim would have failed.

Idemitsu Kosan Co., v. Sumitomo Corporation [2016] EWHC 1909

Bad leaver clauses and the new rule against contractual penalties

Two recent decisions touch on the interaction between bad leaver clauses and the new rule against contractual penalties set out by the Supreme Court in November 2015.

Background: In *Cavendish Square Holdings BV v. Makdessi* [2015] UKSC 67 the Supreme Court distinguished between primary obligations, to which the rules on penalties do not apply, and secondary obligations, to which the rules on penalties do apply. The Supreme Court also stressed that a secondary obligation will be penal if it does not protect a legitimate interest of the innocent party or does so in a way which is not proportionate. (For a more detailed analysis of the Cavendish decision, see The new rule against contractual penalties.)

A bad leaver clause is a compulsory share transfer provision in a company's articles of association or shareholders' agreement. It requires a shareholder who is also a director or employee to offer to transfer his shares in certain circumstances. Typically these relate to gross misconduct or other behaviour justifying summary dismissal. In these circumstances, the transferring shareholder typically receives a discounted price for his shares.

Facts: In *Richards and another v. IP Solutions Group Ltd*, the English High Court had to consider if the defendant, on the facts, could summarily terminate the claimants' service contracts. If it could, the court had to consider whether the bad leaver clause in the company's articles which the defendant had triggered amounted to an unenforceable penalty.

In *Re Braid Group (Holdings) Ltd* [2016] ScotCS CSIH 68, the Inner House of the Court of Session in Scotland was dealing with an unfair prejudice claim under section 996 of the Companies Act 2006. The primary issue was whether a court order could in an order made under that section require the transfer price to be determined by reference to the bad leaver clause in the articles.

In both cases the court's comments on penalty clauses were obiter. They are therefore only of persuasive authority. Nonetheless they offer useful guidance on the judicial approach to bad leaver clauses after *Cavendish*.

In *Richards* the bad leaver clause in the articles stipulated that a bad leaver would get £1 for all the shares that he was required to transfer.

In *Braid* the bad leaver clause stipulated that a bad leaver would get the lower of 75% of the fair value of his shares and the subscription price (including any premium) paid by him.

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Decisions: In both cases the courts found that the bad leaver clauses did not fall foul of the rule against penalties, but for different reasons.

In *Richards* the court recognised that the issue was complex and deserved fuller argument. However, it decided that the leaver provisions in the articles, including the bad leaver clause, were more akin to primary obligations. These were agreed between parties for commercial reasons to do with a shareholder leaving the company, rather than secondary obligations consequent on breach of the employment contract. But even if the clause had been a secondary obligation, there was nothing unconscionable in an arrangement arrived at between parties dealing at arm's length with the benefit of extensive expert advice. Had it been necessary, therefore, the court would have found that transfer provisions in the bad leaver clause were enforceable.

In *Braid*, in contrast, the court agreed unanimously that the transfer provisions in the bad leaver clause were secondary obligations. They backed up a primary obligation to comply with a service contract and provided a mechanism for dealing with the effects of a breach of that primary obligation. On whether the secondary obligations were an unenforceable penalty, two of the three judges considered that they were not. They did not consider it unfair that a shareholder who was guilty of gross misconduct should have to give up his holding and, in return, get back his original financial stake. However, one judge disagreed with this analysis and found the clause to be penal.

Comment: Both courts found that provisions which set a transfer price at a significant discount to market price were, in the context of gross misconduct, enforceable. However, the different conclusions on whether these were primary or secondary obligations show that the boundaries between the two are far from clear. Given that bad leaver clauses are typically triggered on a breach of employment obligations, those wishing to rely on them would be wise to treat them as secondary obligations. Therefore, any compulsory transfer provisions which take effect on a breach should be proportionate to the interest which they are protecting. For example, if there is only a single transfer price for all bad leavers, defining a bad leaver as anyone who is not a good leaver may be more open to challenge than a definition that links being a bad leaver to serious misconduct.

Richards and another v. IP Solutions Group Ltd [2016] EWHC 1835

Re Braid Group (Holdings) Ltd [2016] ScotCS CSIH 68

Solvency statements on a capital reduction

A recent High Court decision includes the first reported court ruling on the factors that directors must consider when deciding whether they can make a solvency statement on a reduction of capital.

Background: Since 2008 it has been possible for a private company to reduce its share capital through the solvency statement procedure in sections 642–644 of the Companies Act 2006. Under section 643, the solvency statement must state that each director has formed the opinion, as at the date of the statement, that:

- there is no ground on which the company could then be found to be unable to pay (or otherwise discharge) its debts; and
- the company will be able to pay (or otherwise discharge) its debts as they fall due during the year immediately following that date.

In forming those opinions, the directors must take into account all the company's liabilities (including any contingent or prospective liabilities). If the directors make a solvency statement without reasonable grounds for the opinions, every director in default commits an offence on delivery of the statement to Companies House.

Facts: The case involved a challenge to certain dividends paid by a company to its parent. To enable it to pay a dividend, the directors had resolved that the company would first reduce its share capital. The claimants argued, among other matters, that the capital reduction was invalid because the solvency statement did not comply with the requirements of the Companies Act 2006. At the relevant time the company had stopped trading. Its principal liability was for certain potentially large environmental liabilities, though the final quantum was uncertain.

Decision: The court dismissed the claimants' case. It found the directors had validly formed the necessary views when they made the solvency statement. In doing so, the court made the following points:

- The directors must actually have formed the opinions set out in the solvency statement. It is not enough that they make a solvency statement that says that they have formed those opinions if in fact they have not – for example, because they misunderstood what the correct test was.
- The "no ground" test is not a technical one but a straightforward one applying the words of the section. The directors must look at the company's situation at the date of the statement. Taking into account contingent or prospective liabilities, they must form an opinion about whether the company is able to pay its debts. If calamity were to strike, the company might be unable to pay its debts, but that does not necessarily mean that, at the time of the solvency statement, the directors cannot make the solvency statement. Equally, it is not necessary to consider whether the court would have jurisdiction to wind up the company under section 123 of the Insolvency Act on the day of the statement.
- The test for whether the directors have taken contingent and prospective liabilities into account is not a technical one. It means the directors need to consider what assets will be available to meet any contingent and prospective liabilities and what provision (in a non-technical sense) has been made for that purpose.

Comment: The court rejected the very strict construction of section 643 put forward by the claimants. It is therefore generally helpful to directors, even if the court did not go into any real detail about the practical application of the requirements of the section.

Perhaps surprisingly, the court found that the absence of reasonable grounds for the directors' opinion does not make the solvency statement invalid, although the directors would, of course, have committed a criminal offence.

BAT Industries plc v. Sequana and another [2016] EWHC 1686

Regulatory update

Takeover Code: changes on communicating and distributing information

There have been recent changes to the Takeover Code. The purpose of these is to ensure that the Code's rules on communicating and distributing information and opinions during a takeover offer adequately reflect recent technological changes, including social media. The changes took effect on 12 September 2016.

A principle underpinning the Code is that the holders of the securities of an offeree company must have enough time and information to enable them to reach a properly informed decision on a bid. The changes focus on how information is communicated and distributed, bearing in mind, also, the principle that all holders of the securities of the same class must receive equivalent treatment. Particular changes include:

- A requirement that where any material new information or significant new opinions are published or provided by or on behalf of it, an offeror or offeree should simultaneously publish the information or opinion through a Regulatory Information Service.
- A requirement that any presentation or other document about an offer or a party provided to, or used in any meeting with, any shareholder or other relevant person must be published on a website promptly afterwards. Any article, letter or other written communication about an offer or a party provided by or on behalf of an offeror or offeree to the media should be published on a website promptly following its publication by the media.
- Restrictions on the use of videos and social media to communicate information or opinions about an offer or a party to an offer.

Takeover Panel Instrument 2016/01

A new Prospectus Regulation

The European Parliament has adopted amendments to the European Commission's legislative proposals for a new Prospectus Regulation to repeal and replace the current Prospectus Directive.

Following a review of the current Prospectus Directive, the European Commission adopted in November 2015 legislative proposals for a new Prospectus Regulation. The European Parliament has now resolved to adopt amendments to the Commissions proposals. Key features of the proposed Regulation in its current form include:

- No EU prospectus will be necessary for capital raisings below EUR 1 million (currently EUR 100,000 threshold).
- No EU prospectus will be necessary for capital raisings addressed to fewer than 350 (currently 150) natural or legal persons per member state and to a total of no more than 4,000 natural or legal persons in the EU. (This excludes qualified and certain other investors.)
- Member states will be able to exempt offers of securities to the public from the prospectus requirement if the total consideration for the offer in the EU does not exceed EUR 5 million. Offers of securities to the public made under this exemption will not benefit from passporting. They will have to clearly state that the public offer is not a cross-border one, and it will not be possible actively to solicit investors outside the member state.

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- There will be a new, simplified prospectus for companies already listed on the public market that want to raise more capital by a secondary issuance.
- A growth prospectus, a simplified standardised document, will be available for offers by SMEs and certain other issuers. However, this will be subject to an exception where the offer relates to securities to be admitted to trading on a regulated market.
- A new prospectus summary, modelled on the key information document required under the Packaged Retail and Insurance-based Investment Products Regulation.
- A new annual "universal registration document" for use by companies that often access the capital markets, containing all the necessary information on a company that wants to list shares or issue debt.

The European Parliament and the Council of the EU will have to adopt the proposed Regulation under the co-decision procedure. Given that the proposed transition period for the Regulation is 24 months after it comes into force, implementation remains some way off. From the UK perspective, Brexit may impact on this.

[Prospectus to be published when securities are offered to the public or admitted to trading]

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