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Good Company

Corporate News

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In this issue

Welcome to the latest edition of *Good Company.*

In this issue, we outline the LSE's proposed changes to AIM's regulatory environment through the introduction of a new rulebook, the AIM Rules for Nomads. Whilst the rulebook largely restates the existing obligations, additional new rules are included (including a requirement for nomads to submit an annual return to the LSE, involving the provision and updating of information in relation to the work a nomad performs on AIM).

In our regular 'Private Equity Focus' column we examine the recent HMRC guidance on the tax treatment of managers' shares in venture capital and private equity backed companies, and give our view of the effect of the revised guidance on the private equity market.

There is also a review of a recent case concerning the use of the phrase "without prejudice" in an agreement, and the practical effect of such decision on future drafting of such provisions.

Finally in this issue, we discuss some points to note in relation to the Government's reform of corporate law. The new Companies Act received Royal Assent on 8 November. Further updates on particular aspects of the reforms will continue to be circulated over this period of change.■

AIM Rules: Changes

By **Chris Brierley**

On 2 October, the London Stock Exchange (LSE) published a consultation paper on changes to the AIM Rules. The main proposal is for the creation of a new rulebook specifically for nominated advisers (Nomads), with minor amendments to the AIM Rules for Companies rulebook.

AIM Rules for Nomads Rulebook

The proposed new rulebook for Nomads largely restates the existing provisions of the AIM Rules for Companies rulebook which are relevant to Nomads and the Nominated Adviser Eligibility Criteria, although certain additional rules are included:

- *The responsibilities of a Nomad* – the rules set out the due diligence which a Nomad should perform before confirming to the LSE that a company is 'appropriate' for AIM.
- *Rule 39* – Rule 39, which sets out the various functions which a Nomad must perform, is extended, so that a Nomad must contact the LSE immediately if it has concerns about the appropriateness of a company after its admission to AIM, and provides guidance on what the LSE expects from a Nomad in relation to its responsibility to act with due skill and care. The declaration which a Nomad must make on admission of an applicant to AIM has been amended to reflect these changes.
- *Direction of Nomads* – in exceptional circumstances, the LSE will be able to direct the actions of Nomads to preserve the orderliness or reputation of AIM.
- *Annual returns* – Nomads will be required to submit an annual return to the LSE, which will be used by the LSE to monitor compliance and assess whether a Nomad continues to be eligible. The annual return will need to include information on the 'relevant transactions' carried out by the Nomad in the period to which the return relates and the 'qualified executives' employed by the Nomad.

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Additional Disclosure

It is proposed that companies on AIM will need to maintain a website setting out key information, including a description of the company's business; its directors, and a brief biography on each of them; its country of incorporation and main country of operation; the most recent annual report; all announcements made to the market and all prospectuses, admission documents and similar documents published in the previous 12 months; and details of the company's key advisers.

Moreover, an extra statement will need to be included on the front of each admission document, setting out the Nomad's duties.

Amendments to the AIM Disciplinary Procedures and Appeals Handbook

It is proposed that this handbook will set out an explanation of the LSE's approach and rationale to the disciplinary process, and the factors which it will take into account in deciding whether to take disciplinary action.

The concept of a 'warning notice' will be introduced; such a warning will be given where an investigation has been carried out and the LSE believes that a breach has occurred which does not justify a fine, censure, or more serious sanction. A warning notice will form part of the compliance record of the company or Nomad which has received it, and will be taken into account in the event that any further breach occurs. The cap on fines which can be levied by the AIM Executive Panel will be raised from £25,000 per breach to £50,000 per breach.

Comment

Although the new rules will not come into force until early 2007, the LSE has stated that the rules are intended to reflect existing good market practice and, as such, it expects Nomads to comply with the rules with immediate effect. The revised AIM rules, along with a marked-up version, are available on the LSE website: www.londonstockexchange.com.

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Private Equity Focus

Tax Treatment of Equity Ratchets

By **Elise Bragg**

In August of this year, HM Revenue & Customs ("HMRC") issued new guidance on the tax treatment of managers' equity investments in venture capital and private equity backed companies following receipt of advice from legal counsel.

Background

In private equity transactions, it is traditional to incentivise management through ratchet arrangements whereby management's proportionate entitlement to equity in a company is increased if certain agreed performance targets are met. Since the publication of Schedule 22 to the Finance Bill 2003 on 16 April 2003, there has been significant debate as to whether any gains realised on exit should be subject to capital gains tax only or whether, where the gain is disproportionately large, the share disposal proceeds should also incur income tax and national insurance contributions.

The Joint Memorandum of Understanding

A joint memorandum of understanding ("MOU") between the BVCA and HMRC published on 25 July 2003 set out the conditions for ratchet arrangements which needed to be satisfied in order to ensure that there would be no further liability, arising from the ratchet itself under Chapters 1-5 of Part 7 of the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA"). The conditions provided that:

- the ratchet arrangements must not vary according to the personal individual performance of any particular holder of shares;
- the ratchet arrangements be in existence at the time the venture capital/private equity provider acquired his shares; and
- the managers pay a price for their shares in the ordinary capital that, at the time of acquisition, reflects their maximum economic entitlement.

HMRC's FAQ's

Subsequently, HMRC issued FAQ4(a) and (c), giving HMRC's view and setting out a formula as to how a Chapter 4 ITEPA benefit charge on a ratchet might be calculated where the ratchet did not meet the conditions and suggesting that a benefit charge might arise where a company was thinly capitalised, where this

gave rise to a disproportionate reward to a manager (i.e., because the managers do not invest as much debt on a pro rata basis as the venture capital/private equity provider, the managers are in a position to make an increased rate of return on their investment).

Advice on the applicability of a benefit charge was sought from legal counsel who advised that a benefit charge was not sustainable where the benefit to the holder of the shares from the ratchet reflected rights already present in that class of share at the time of acquisition by the manager, or in terms of a thin capitalisation argument.

Revised Guidance

Following receipt of the advice, HMRC has withdrawn the guidance provided in FAQ4(a) and (c). The revised guidance is that where shares are acquired in accordance with the requirements laid down in Sections 1-5 of the MOU then, where there is a ratchet operating at an exit, no benefit charge will arise on the disposal of such shares or, if earlier, on operation of the ratchet. In addition, where the conditions are met (as above), any gains realised on exit will be subject to CGT only and not Income Tax or National Insurance Contributions. HMRC continues to maintain, however, that where the arrangement does not satisfy the MOU or where the conditions are not met, charges remain possible.

In our view, the revised guidance is a positive step in clearing up the considerable uncertainty arising from HMRC's different interpretation of the MOU.■

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"Without Prejudice" – Beware

By **James Stonehill**

The Court of Appeal has recently considered how the words "without prejudice" affected two clauses in an acquisition agreement.

Facts

A purchaser acquired some shares from a seller. The seller gave a number of warranties to the purchaser, including in relation to management accounts.

Clause 6.3 of the agreement stated that "any Claim under the Warranties which shall not have been notified ... on or before the third anniversary of the completion date ... shall be deemed to have been waived".

Clause 6.4 stated that "Without prejudice to clause 6.3, [the purchaser] shall notify [the seller] in writing as soon as practicable after the date upon which [the purchaser] becomes aware of a claim" and that such notification should contain details of the claim.

Two months before the third anniversary of completion, the purchaser wrote to the seller notifying the seller of discrepancies in the management accounts. On the third anniversary of completion, the purchaser wrote to the seller to give its intention to make a claim and the letter stated that the purchaser would write further in due course. One year later, the purchaser issued proceedings for breach of warranty. The seller argued that the claim was time barred under clause 6.3.

Decision

The Court of Appeal's judgment was in favour of the purchaser. The court held that clauses 6.3 and 6.4 were quite separate from each other and had different legal effects. Clause 6.3 operated as a contractual time-bar. Clause 6.4 however imposed a contractual obligation to notify the warrantors as soon as was reasonably practicable after the date on which the claimant became aware of a claim against them.

The words "without prejudice to the provisions of clause 6.3" were held to mean that the provisions of clause 6.4 were not imported into the provisions of clause 6.3. Clause 6.3 was independent from clause 6.4.

Comment

The decision in *Forrests and others v. Glasser and Whitley* is not entirely surprising given the particular wording of clauses 6.3 and 6.4. However, the judgment is a reminder that the words "without prejudice" should be used with care in order to avoid contractual provisions having an unexpected outcome.■

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Companies Act 2006

By Julie Albery

The wholesale reform of company law under the Companies Bill received Royal Assent on 8 November, introducing sweeping changes to simplify and improve company law.

Company law has been substantially rewritten to make it easier to understand and more flexible—particularly for small businesses.

Secretary of State Alistair Darling said:

This Act will ... make sure the regulatory burden on business is 'light-touch', promote shareholder engagement and will help encourage a long-term investment culture in the UK.

Initial Stage

The first measures to be introduced will include provisions on company communications to shareholders. These will be introduced in January 2007, and, according to the DTI, will save businesses over £50million by allowing electronic communications with shareholders rather than paper.

The clauses on takeovers which give the Takeover Panel power to make rules within a statutory framework will also be one of the first areas introduced. Measures relating to disclosure to the market and clarification of the liability attaching to such disclosures will also come in at an early stage.

Other Areas

The new Act:

- includes measures giving greater clarity on the duties of directors, including making clear that they have to act in the interests of shareholders, but in doing so have to pay regard to the longer term, the interests of employees, suppliers, consumers, and the environment;
- encourages narrative reporting by companies to be forward-looking, covering risks as well as opportunities, with explicit requirements for quoted companies;
- includes an option for all directors and shareholders to file a service address on the public record rather than a private address;
- promotes shareholder engagement through enhancing the powers of proxies, and making it easier for indirect investors to be informed and exercise governance rights in the company;
- includes provisions allowing shareholders to agree limits on the liability of auditors to the company to what is fair and reasonable;
- includes a new offence for recklessly or knowingly including misleading, false, or deceptive matters in an audit report; and
- requires institutional investors to disclose how they use their votes. The Government has, however, made clear that they hope that the market will provide such disclosure without the need to exercise the power.

Note that some clarity has also been provided on what the government expects to be reported in a company's Business Review in relation to the widely reported (and controversial) supply chain arrangements. We understand that the new provisions are not intended to impose an obligation to list suppliers and customers or to provide details about contracts. The provisions are instead about reporting significant relationships, such as major suppliers or key customers critical to the business, and which are likely to influence, directly or indirectly, business performance and value. It will be for the directors of the company to exercise their judgment on what they need to report. By way of example, reliance by a company on a single supplier for a key component such that if the supplier were to go bust, causing a serious impact on the company's business, would be disclosable.

Private Companies

The Act also includes measures to benefit private companies including:

- new model articles;
- no need to have a company secretary unless the company wants to have one; and
- no need to have an AGM unless the company wants to hold one.

Comment

The government has confirmed that all parts of the Act will be in force by October 2008, so, whilst there is some time before implementation, companies should begin to consider its effects now. Further updates on particular aspects of the Act will be provided over the course of this period.

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