DechertOnPoint

Spring 2006 / Issue 14

Editors: harriet.smith@dechert.com and christopher.brierley@dechert.com

Good Company

Corporate News

In this issue

Parliament Tackles Business Reform

By **David N. Vogel,**
Head of Corporate

The most significant legislative changes set to hit the business community for more than 20 years are gathering pace as Parliament digests the Company Law Reform Bill.

The mood in the business community is one of cautious optimism. Many (the CBI and the Institute of Directors included) welcome any simplification of the law and reduction of the regulatory burden on smaller businesses. Others (such as the Association of British Insurers) anticipate an unwelcome increase in the regulation of directors. Some fear a surge in shareholder litigation actions against directors and worry that the bill's good intentions risk being lost in translation by the legislature, especially given its size and complexity (885 clauses in all).

While the DTI estimates that the bulk of the reform will come into force by early 2007 (with implementation of provisions enacting the Takeover Directive expected later this year), some commentators have questioned the likelihood of this time frame being met. Mounting parliamentary opposition to key elements of the legislation could slow things down considerably. Quite how this all pans out remains to be seen, but businesses are well advised to keep a close eye on developments.

In this issue, along with our usual features and round-up of developments, our focus is on the practical implications the new legislation may have for our readers. I hope you find Good Company useful in enhancing your awareness of these important issues.

david.vogel@dechert.com

Dechert LLP

OFR: What Now?

By **Chris Brierley**, Associate

In March 2005, an amendment to the Companies Act 1985 required all companies incorporated in Great Britain and listed on the Official List or certain foreign exchanges to prepare an Operating and Financial Review (OFR) for financial years beginning on or after 1 April 2005. OFRs were intended to provide analysis of, among other things, the development and performance of the company during the financial year. The reviews had to cover information on the company's policies relating to employees, the environment, and social and community issues.

On 28 November 2005, Gordon Brown announced the Government's intention to abolish the requirement to produce OFRs, with the stated aim of removing additional burdens on companies. The requirement was abolished on 12 January 2006.

What does this mean for those companies which had an obligation to report?

It is clear that any preparations for the OFR will still be of value. Save for small companies, each company incorporated in Great Britain must include a review of the business of the company and the principal risks and uncertainties with which it is faced in its directors' report. A "small company" is one that satisfies two of the following criteria: a turnover of not more than £5.6 million; a balance sheet total of not more than £2.8 million; and not more than 50 employees.

This business review must provide a "balanced and comprehensive analysis" of the development and performance of the business of the company during its financial year and the position of the company at the end of that year. The review must contain an analysis which uses financial key performance indicators and, where necessary, analysis using other key performance indicators.

Medium-sized companies need not include analysis using key performance indicators insofar as such indicators relate to non-financial information. A "medium-sized company" is one that satisfies two of the following criteria: a turnover of not more than £22.8 million; a balance sheet total not more than £11.4 million; and not more than 250 employees.

Additional Guidelines

On 24 January 2006, the Department for the Environment, Food and Rural Affairs published new guidelines in relation to the environmental element of the business review, which included key performance indicators, to assist companies in the preparation of their business reviews. Environment Minister Elliot Morley stated that these guidelines could be used by all companies, and not just those under a legal obligation to prepare the business review.

Moreover, the Accounting Standards Board (ASB) has issued a statement that it is keen for companies to produce OFRs on a voluntary basis, to accompany annual reports. The ASB recommends that directors prepare an OFR addressed to members containing a forward-looking analysis of the business to enable members to assess the strategies adopted and the potential for such strategies to succeed.

At the beginning of February, the Government performed a U-turn: the existing consultation on the business review was extended from 15 February 2006 to 24 March 2006, and widened to invite comments on social, community, employee and environmental matters – all of which were dealt with in the abolished OFRs. Uncertainty will remain in this area until the consultation has closed and the changes incorporated in the Company Law Reform Bill currently going through Parliament.

christopher.brierley@dechert.com

Shareholders' Rights

By **James Stonehill**, Associate

The European Commission has recently published a draft directive on the voting rights of shareholders. The directive aims to ensure that shareholders, no matter where they are in the EU, have timely access to information and are able to exercise voting rights at a distance. It is proposed that the directive will apply to companies whose shares are traded on a regulated market; the directive will therefore apply to Official List companies but not those listed on AIM.

The proposals include the following:

General meeting notice period

Any notice convening a general meeting will need to be sent out at least 30 *calendar* days before the meeting. The new proposal is not much longer than the 20 *business* days recommended by the Combined Code for annual general meetings. However, 30 calendar days' notice is significantly longer than the notice period currently required for extraordinary general meetings (that is, 21 clear days where a special resolution is proposed and 14 clear days where an ordinary resolution is proposed). An EGM being held on 30 calendar days' notice in relation to an equity fundraising would probably increase underwriting costs.

Agenda

Shareholders will have the right to add items to the agenda of general meetings. This right will usually be restricted to those shareholders who hold a minimum proportion or number of shares; the minimum stake required to benefit from the right under the directive should not exceed 5 per cent of the share capital or €10 million, whichever is the lower.

Shareholders' Questions

Shareholders will have the right to ask questions at or before a meeting. Companies will be obliged to publish responses on their websites although there will be exemptions (for example, the protection of confidentiality and business interests of companies).

Votes Cast

The draft directive provides that "all votes cast in relation to any resolution submitted to the approval of a general meeting shall be taken into account". It is not clear exactly what this means and whether or not all votes will need to be dealt with on a poll rather than a show of hands.

Proxies

Proxy voting should not be subject to excessive additional requirements, neither should it be unduly restricted. However, for the good order of general meetings, a shareholder may only appoint one proxy in respect of his entire voting entitlement.

Postal Voting

Shareholders should have the opportunity to vote by post in advance of general meetings, subject to such requirements as may be necessary to ensure the identification of shareholders. The Commission notes that where shareholders hold registered shares and are known to the company, the easiest and cheapest way to cast votes remains the postal vote.

The Commission is proposing that the directive should be implemented by the end of 2007, which some see as an adventurous time frame. The DTI has said that it supports the principles in the directive but there are some cross-border issues which need to be addressed before implementation.

james.stonehill@dechert.com

From the Courts

Tax Residency: Central Management and Control

By **Mark Stapleton**, Head of Tax

Corporate and fund structures involving non-UK incorporated companies have been forced to sit up and take notice by a recent Court of Appeal decision. In Wood and another v. Holden, the court reviewed the test of where the central management and control of a company abides (in determining whether a non-UK incorporated company can be considered to be UK tax resident).

Facts

The Woods appointed the UK offices of Price Waterhouse Corporate Finance (Price Waterhouse) to locate a buyer for their company. Price Waterhouse devised a scheme which involved the disposal of certain shares by a company incorporated in the British Virgin Islands (CIL) to its subsidiary incorporated in the Netherlands (Eulalia), of which a company based in the Netherlands (ABN Trust) had been appointed as sole managing director.

If gains accrued to CIL on the disposal of shares to Eulalia, the effect was that chargeable gains would be treated as accruing to the Woods. However, if CIL and Eulalia were accepted to be "non-resident companies which are members of a non-resident group of companies", the disposal would fall within section 171(1) of the Taxation of Chargeable Gains Act 1992 by virtue of section 14 thereof and the relief for "intra-group" disposals would apply.

The Revenue did not accept the Woods' contention that Eulalia was not resident in the UK and argued that section 171(1) relief did not therefore apply to the disposal.

Central Management and Control/ Residence

The Special Commissioners held on the basis of the following findings of fact that the management and control and therefore the residence of Eulalia abided in the UK:

- ABN Trust was appointed as managing director of Eulalia at the behest of Price Waterhouse;
- The final form of agreement, executed on behalf of Eulalia by representatives of ABN Trust, was in substance in identical terms to Price Waterhouse's draft sale agreement;
- There was no documentation as to the basis of the price for the disposal. There was no record of an explanation being given by Price Waterhouse or of any advice being received by ABN Trust in respect of the transaction.

The Special Commissioners considered that the mere physical acts of signing resolutions and executing

documents did not suffice for actual management, neither did the mental process which precedes the physical act. What was needed was an effective decision as to whether or not the resolution should be passed and documents signed or executed, and such decisions required some minimum level of information. The Special Commissioners said that ABN Trust had given no real consideration to the matter, but had simply fallen in with the wishes expressed by Price Waterhouse.

The judge at first instance disagreed with the Special Commissioners' decision and held that Eulalia was resident in the Netherlands. The judge said that the making of board resolutions and the signing and execution of documents were the only acts of management and control of Eulalia and these all took place in ABN Trust's Dutch offices. The judge considered that it was not the law that the central control and management test is superseded by some different test if the business of a company is such that not a great deal is required for the central control and management of its business to be carried out.

The Court of Appeal upheld the judge's ruling. The court held that there was no evidence that Price Waterhouse had dictated ABN Trust's decisions, although Price Waterhouse had expected and intended that ABN Trust would make such decisions. Furthermore, a management decision did not cease to be a management decision because it might have been taken on further information.

The court said that there was a distinction between cases where the management and control of a company is exercised through its own constitutional organs and cases where the functions of the constitutional organs are usurped. Within the former class, there was a further distinction between the role of an 'outsider' in proposing, advising on and influencing a decision which the constitutional organs take in fulfilling their functions and the role of an outsider who dictates the decisions which are to be taken.

Comment

This case is of fundamental importance to many corporate and fund structures involving non-UK incorporated companies. While the decision is favourable to the taxpayer, it does reaffirm the key principles that must continue to be observed to avoid such companies inadvertently becoming subject to tax in the UK.

The UK advisers to a company should be careful to ensure that the constitutional organs of the company are not usurped, and further that they do not dictate the decisions to be taken by the directors. It is important that steps are taken and procedures put in place to ensure that this is demonstrably the case.

mark.stapleton@dechert.com

Deal Watch

Dechert Advises on SQS's AIM Admission

Dechert advised SQS Software Quality Systems AG (SQS) on its admission to trade on the AIM market of the London Stock Exchange. SQS is based in Cologne, Germany, and is the first German company to have a primary listing in London. Dechert advised SQS both on the AIM admission and a related £10.8 million placing of ordinary shares with institutional investors. At float, the company was valued at approximately £30 million.

One of the largest independent European providers of software testing and quality management services, SQS has been providing a comprehensive range of consulting services for enterprise and technical software systems for more than 20 years. Its clients include blue chip companies in a variety of industries, including financial services, telecommunications, logistics and manufacturing.

David Vogel, London's head of business law, who led the Dechert team, said: "It was extremely satisfying to help SQS become the first German company with a primary stock exchange listing in London. In addition to advising SQS from London on the float, our Munich office provided a comprehensive service dealing with German legal and corporate matters. In particular, we were able to identify and solve the complex issues surrounding clearing and settlement of German securities. We wish SQS well as a listed company and look forward to helping it develop in the future."

In addition to David, Sean Geraghty assisted on corporate matters and Federico Pappalardo and Volkmar Bruckner, of Dechert's Munich office, advised on German law.

Private Equity Focus

Dechert Advises on Cross Border LBO of Specialty Steel Business

Dechert has advised Jefferies Capital Partners and its portfolio company Edgen Corporation (Edgen) on the acquisition of Murray International Metals Limited (MIM). The completed transaction created a new parent, Edgen/Murray, L.P. - which owns 100% of both Edgen and MIM. The transaction involved an initial acquisition by Edgen of the US business of MIM followed by the purchase of MIM by Edgen/Murray, L.P. The acquisition was partly financed by two bond issues in the US together with a sale and leaseback of MIM's principal property.

Edgen is a leading global distributor of highly specialised steel pipe and fittings for use in the oil and gas industries, processing and power generation industries and is now complemented by MIM, which is a distributor of structural steel products for use in offshore oil and gas exploration and production industry.

Dechert's US team was headed by client partner Carmen Romano. The bond financing was led by partner Brian McCall and Zain Husain and the acquisition was led by partner David Wallis, assisted by Sean Geraghty, Daniel Jacob and Chris Brierley.

Life Sciences Focus

Twelve Months on from the Myners Report—Has Anything Changed?

By **Charles Waddell**, Counsel

Shareholders expect protection from unwanted wealth transfer and erosion of control, which can occur if a company's directors were to issue shares for cash to third parties at a discount, for example. Designed to guard against this kind of abuse, mechanisms known as pre-emption rights are enshrined in the Companies Act 1985. These provide that any company proposing to allot shares for cash must first offer the shares to existing shareholders pro rata to their existing shareholdings. The statutory pre-emption rights may be excluded by a company by a special resolution passed at a general meeting of shareholders. The Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF) have long sought to restrict the ability of listed public companies to seek general exclusions of pre-emption rights. These restrictions are to be found in the Pre-Emption Group's Guidelines.

Clearly, not all parties share the same interests here. When a DTI Commission, headed by Paul Myners, reviewed pre-emption rights in 2004, the biotechnology industry lobbied to get pre-emption rights either abolished or severely curtailed, in order that they could raise funds on a level playing field

to their US counterparts. US biotech companies have long been able to use so-called PIPEs (private investment in public entities) to raise equity finance on a non pre-emptive basis. The final report, known as the Myners Report, was published in February 2005. Twelve months down the line, the question remains: have we really seen any substantive changes in the levels of pre-emption waivers achieved by companies within the biotech sector?

In his final report, Myners concluded that statutory pre-emption rights on new share issues ought to be retained but that companies with a good reason, story or skill (such as biotech companies) should be prepared to seek higher annual disapplication levels than those set out in the Guidelines. The Guidelines recommend that the maximum level of waiver from the statutory pre-emption rights should be limited to 5 per cent of the issued share capital in any one year and a maximum of 7.5 per cent of the issued share capital in any rolling three-year period. Although the Guidelines state they should be treated as guidelines, Myners noted that for many companies they have achieved the status of 'absolute' rules, and investors were highly unlikely to vote in favour of any resolution seeking a higher level of disapplication.

A key theme from the final report was flexibility and choice. Myners effectively challenged biotech companies and their institutional investors to see if larger maximum levels of disapplication can be granted, and whether such a situation was workable so as to allow companies greater flexibility to raise capital, while retaining investor confidence.

The Government has been placing a greater emphasis on shareholder engagement. The Myners Report positively encouraged companies to approach their shareholders in order to request higher levels of pre-emption waiver. The ground has been prepared to create a situation that could see much higher levels of disapplication being achieved.

Since the publication of the Myners Report in February 2005, many of the UK's biotech companies have had the opportunity to put the recommendations of the report to the test. In looking at 20 biotech companies in the UK, there have been mixed results.

The following table shows that 20 listed biotech companies sought and obtained a disapplication at their 2005 AGM. Eleven sought and achieved a pre-emption disapplication of more than 5 per cent, demonstrating that there has been some movement on the part of shareholders to agree to a higher pre-emption waiver than was generally considered acceptable under the Guidelines. It is worth noting that some biotech companies, such as Antisoma, had sought and obtained a disapplication level higher than 5 per cent in the years prior to the Myners Report. Interestingly, not one company proposed a higher level than was later accepted at the general meeting.

Company Name	Disapplication achieved (%)
ACAMBIS	5
ALIZYME	6.15
ANTISOMA	20
ARDANA	10
ARK THERAPEUTICS GROUP	5
AXIS-SHIELD	5
CAMBRIDGE ANTIBODY TECHNOLOGY GROUP	5
GENEMEDIX	5
GOLDSHIELD GROUP	10
M.L.LABORATORIES	7.23
OXFORD BIOMEDICA	10
PHARMAGENE	5
PHYTOPHARM	10
PROTHERICS	10
PROVALIS	10
SHIRE PHARMACEUTICALS	5
SKYEPHARMA	5
THERATASE	5
VERNALIS	6.4
XENOVA GROUP	10

What the table does not show is the level of dialogue that passed between biotech companies and their shareholders before the disapplication resolutions were put to the AGM.

It seems that Myners has achieved his wish and there are signs that companies have been able to get a higher disapplication than before. Whether his recommendations have gone far enough and created the right climate to give the biotech companies the flexibility that their boards have been seeking remains to be seen.

charles.waddell@dechert.com

Directors' Duties and the Company Law Reform Bill

By **Paul S. Rosen**, Associate

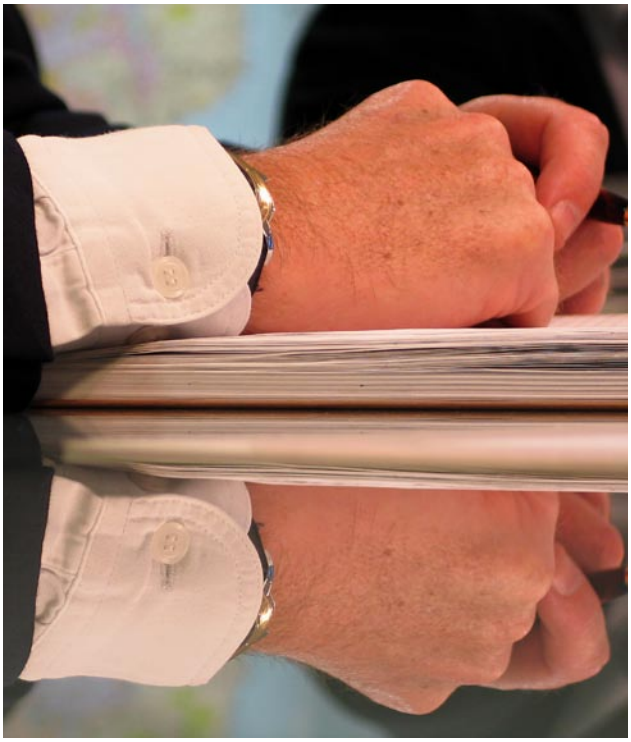
For many years directors have understood their duties to be principles formulated by the courts. Is the proposed Company Law Reform Bill about to give directors a statutory checklist of their duties for the first time?

What is the current position?

Duties of directors of both private and public limited companies are governed by principles set out in common law and equity. These include the duties of exercising due care and skill and diligence; loyalty; obedience; not making a secret profit; independence; avoiding conflicts of interest; considering the interests of employees; and exercising fairness between shareholders.

What is proposed under the Company Law Reform Bill?

For the first time, the new bill will codify directors' duties in one place. It will replace all common law and equitable rules, although those rules will still apply in the interpretation of the statute.



The bill introduces a new concept of "enlightened shareholder value". This approach is being designed to drive "long-term company performance and maximise overall competitiveness".

What are the proposed directors' duties?

Many of the existing duties are, in general, replicated in the bill. These duties are still owed to the company itself and not the shareholders, though other stakeholders' interests must now be considered. The new bill will apply as previously to shadow directors. There is still no distinction drawn between executive and non-executive directors.

- *Duty to act within the company's powers.*
- *Duty to promote the success of the company.*
  This is a new duty. The duty is owed to shareholders as a whole. However, in exercising this duty, directors must also take into account factors such as employees, relationships with suppliers and customers, and the environment. It will be difficult to assess what this duty entails as the wording used has changed from the common law "acting in the best interests of the company".

  A shareholder may now be able to bring proceedings on behalf of the company against a director for negligence, default, breach of trust or duty by not taking account of a particular pressure group's interests.

  The DTI expects directors to take action and not just pay lip service to these proposed duties. However, in the event of a takeover, it is unclear how directors will weigh all these factors in establishing a best price for shares.
- *Duty to exercise independent judgment.*
  This codifies the common law. Directors will be able to delegate duties if provided in the articles.
- *Duty to exercise reasonable care, skill and diligence.*
  This is similar to the existing common law principle. It imposes both a subjective and an objective test, that is, what a director does know and what a director should know.
- *Duty to avoid conflicts of interest.*
- *Duty not to accept benefits from third parties.*
- *Duty to declare interest in proposed transaction or arrangement with the company.*
  This goes slightly further than the current law, with directors having to disclose matters of which they should reasonably be aware and to update a declaration if it becomes inaccurate.

What is the current status of the bill?

The bill is currently with the House of Lords, which is proposing amendments. It reached committee stage on 30 January 2006. It is expected that the bill will be passed later this year and that these provisions will become effective in spring 2007.

What is the effect of the proposed changes?

The CBI is concerned that people, will be deterred from becoming directors, especially non-executive directors. There are also fears that there are greater risks of claims from parties other than shareholders - for example, activists, lobby groups and employees.

Directors will also be more wary of delegating responsibility to committees and company board meetings may get very much longer.

paul.rosen@dechert.com

The Prospectus Directive and Employee Share Schemes: Points to Consider

By **Harriet Smith**, Associate

The Prospectus Directive (PD) requires a prospectus to be produced if there is an offer of transferable securities to the public (section 85(1) FSMA). Companies should consider whether an offer of options or shares under their employee share scheme will constitute an offer to the public for the purposes of the PD and therefore whether a prospectus will be required.

Does the Prospectus Directive apply?

Whilst most regulators would probably agree that they have no desire to review prospectuses relating to employee share schemes, the interpretation of how the PD applies to employee share schemes can vary considerably between member states. A company concerned about whether their employee share scheme triggers the requirement to produce a prospectus must first establish whether there is, in fact, an offer of transferable securities to the public.

In relation to a share option scheme the first consideration should be whether or not the options are, in fact, "transferable securities". Transferable securities for the purposes of the PD must be "negotiable on the capital market". This is generally considered to refer to whether the security is freely tradable rather than whether it is listed. The FSA has indicated in informal guidance that share options would not be considered to be transferable for the purposes of the PD and an employee share option scheme would therefore fall outside the scope of the PD. This view appears to be shared by the Spanish and German regulators.

There is a further question as to whether a grant of options might constitute an offer of the underlying shares, which *would* be "transferable securities". However, as the FSA's view (based on informal guidance) seems to be that employee shares schemes were not intended to be covered by the PD it seems unlikely that such a line would be pursued by them. This approach is shared by the Spanish regulator. The German regulator, however, has expressed the view that if the underlying shares are transferable, there would be an offer to the public at the point at which the options become exercisable and in the absence of any applicable exemption, a prospectus would be required under the PD.

If it is considered that the options or shares being offered under the scheme are indeed "transferable securities", the second consideration should be whether there is "an offer of transferable securities" to which the PD applies. The directive will only apply if the value of the entire offer is more than €2.5 million. For the purposes of calculating the value of the offer, the offer should be taken together with any other offer of the same class of transferable securities made by the same person which was open within a period of 12 months prior to the proposed offer, and itself was less than €2.5 million.

A further difficulty when applying this test to options is the interpretation of "consideration": this is generally considered to mean "value" but in relation to options the question is whether the value of the option itself or the value of the underlying share should be taken into account. In relation to schemes involving free shares, relying on the fact that the employees are not giving consideration for their transferable securities would be risky and the value of those shares should be taken into account.

However, in Germany the implementing law only exempts offers of less than €2.5 million under certain conditions. The German regulator has suggested to us (by way of informal oral guidance) that in circumstances where beneficiaries are individually characterised and listed by the company, the vesting of the options, resulting in an offer of underlying shares, would not be a public offer subject to the PD.

Exemptions

- *100 persons exemption*
  In the PD itself, and also the UK legislation implementing the directive, this exemption is stated as applying only if there are fewer than 100 persons (excluding qualified investors) per member state. This will be a question of fact. If the offer is made to more than 100 persons in one member state the exemption will not apply in any member state. This interpretation is also applied by the Spanish regulator.

  While the question of whether there are 100 persons is not calculated on an aggregate basis over 12 months (as initially intended) in order to ensure the exemption is not abused, the FSA will monitor on a case-by-case basis whether successive offers constitute a single offer for the purposes of the exemption.

  Oddly, the German regulator has said, in its informal oral guidance, that it will only require a prospectus if the offer is to more than 100 persons within Germany.

- *Employee share option*
  The directive does provide for an exemption for employee share option schemes. However, this is limited to offerors who are listed on a regulated market. This means that AIM listed companies would not be able to use this exemption.

Conclusion

There is a large degree of uncertainty as to how the PD applies to employee share schemes and that is not helped by the fact that each member state interprets the PD and its implementing legislation very differently. While it should be remembered that the PD is not generally perceived to be intended to cover employee share schemes, it is worthwhile taking the time to review such schemes to ensure the risk of having to produce a prospectus is minimised.

harriet.smith@dechert.com

Keeping Up to Date on Latest Developments

Publications

Requesting our latest free publications:

- Rent Arrears – Landlords' Remedies against Insolvent Tenants: (Wallchart) A guide to the changes to the Landlord and Tenant Act 1954
- Becoming a Director – a guide to the issues involved
- Changes to the Scope of the Data Protection Act
- Labour and Employment Law in England and Wales – July 2004
- Promoting More Flexible Investment in Property – executive summary
- Surviving as a Director - a guide to your role and responsibilities
- The Higgs Review on NEDs (January 2003) – summary recommendations and the combined code
- Transferring Data out of the EU – Becoming compliant by following the recently sanctioned 'Binding Corporate Rules'
- Workplace Dispute Resolution

■ ■ ■

For further information on seminars or to receive any of these publications, please photocopy this page and return it with a copy of your business card to Marketing, Dechert LLP, 160 Queen Victoria Street, London EC4V 4QQ. Alternatively, e-mail goodcompany@dechert.com

GOOD COMPANY FOR YOUR INBOX

If you would like to receive your copy of Good Company via email, please send your email address to goodcompany@dechert.com with "EMAIL ME" in the subject field and we'll ensure that our lists are amended accordingly.

goodcompany@dechert.com

Dechert LLP • 160 Queen Victoria Street, London EC4V 4QQ
Tel: +44 20 7184 7000 • Fax: +44 20 7184 7001 • Email: goodcompany@dechert.com • Web: www.dechert.com

Dechert LLP

www.dechert.com

UK/Europe
Brussels
Frankfurt
London
Luxembourg
Munich
Paris

US
Austin
Boston
Charlotte
Harrisburg
Hartford
New York
Newport Beach
Palo Alto
Philadelphia
Princeton
San Francisco
Washington, D.C.