principally, with companies formed under particular Acts of Parliament does not convey much by way of understanding what role such companies perform in society.

The term "company" implies an association of a number of people for some common object or objects. The purposes for which men and women may wish to associate are multifarious, ranging from those as basic as marriage and mutual protection against the elements to those as sophisticated as the objects of the Confederation of British Industry or a political party. However, in common parlance the word "company" is normally reserved for those associated for economic purposes, i.e. to carry on a business for gain.[2] But it would be wrong to say that company law is concerned only with those associations which people use to carry on business for gain—and for two reasons. First, companies are not the only legal vehicles which people may use in order to associate for gainful business. Secondly, companies incorporated under the Companies Acts may be used for carrying on not-for-profit businesses, or for purposes which can be only doubtfully characterised as businesses at all. We will look at each of these matters in turn.

Business vehicles: companies and partnerships (limited and unlimited)

Partnership Act 1890 and Companies Act 2006

1–2 English law provides two main types of organisation for those who wish to associate in order to carry on business for gain: partnerships and companies. Historically, the word "company" was colloquially applied to both,[3] but the modern lawyer regards companies and company law as distinct from partnerships and partnership law. Partnership law, which is now largely codified in the Partnership Act 1890, is based on the law of agency, each partner becoming an agent of the others,[4] and it therefore affords a suitable framework for an association of a small body of persons having trust and confidence in each other. A more complicated form of association, with a large and fluctuating membership, requires a more elaborate organisation which ideally should confer corporate personality on the association: that is, it should recognise that it constitutes a distinct legal person, subject to legal duties and entitled to legal rights separate from those of its members. This the modern company can provide easily and cheaply by permitting incorporation under a general Act of Parliament, the current such Act being the Companies Act of 2006.

1–3 This might seem to imply that the difference between partnerships and companies is that the former is used to carry on small businesses and the latter large ones (or, better, that the former is used by a small number of people to carry on a business and the latter by a large number). The mid-Victorian legislature was, it seems,

[2] But not universally; we still talk about an infantry company, a livery company and the "glorious company of the Apostles".
[3] So that it was common for partners to carry on business in the name of "—& Company".
[4] Partnership Act 1890 s.5.

animated by some such idea.[5] Partnership numbers were capped by statute, and incorporation was compulsory for larger numbers of people associating themselves for business purposes. Thus, s.716(1) of the Companies Act 1985, re-enacting a provision first introduced by the Joint Stock Companies Act 1844 (which in fact set the limit slightly higher at 25), provided that, in principle, an association of 20 or more persons formed for the purpose of carrying on a business for gain must be formed as a company[6] (and so not as a partnership); whilst the Limited Liability Act 1855 required companies with limited liability to have at least 25 members.[7] However, the Joint Stock Companies Act 1856 quickly reduced the minimum number to seven for companies,[8] and the decision of the House of Lords at the end of the nineteenth century in *Salomon v Salomon*[9] in effect allowed the incorporation of a company with a single member, the other six being bare nominees for the seventh. This judicial decision preceded by nearly a century the adoption of EC Directive 89/667,[10] which required private companies formally to be capable of being formed with a single member. The 2006 Act extended this facility to public companies.[11] As for the maximum limit for partnerships, this too has been eliminated over the past two decades, thus, the 2006 Companies Act contains no equivalent to s.716 of the 1985 Act.

But this eventual collapse of the Victorian segregation of the two business forms does not mean that they are equally well adapted to different sizes of business. In fact, it is clear that where a large and fluctuating number of members is involved, the company has distinct advantages as an organisational form. This is because the company has built into it a distinction between the members of the company (usually shareholders) and the management of the company (vested in a board of directors). Although this division can be replicated within a partnership, it has to be distinctly chosen by the partners, since the default rule is the less practical universal participation in management.[12]

Limited Liability Partnerships Act 2000

1–4 On the other hand, where a small number of persons intend to set up a business and all to be involved in running it, the distinction made by company law between shareholders and directors often becomes a nuisance, for they are the

[5] Though the legislature seems to have been influenced in this view more by problems of civil procedure in relation to large partnerships than by the idea that the partnership itself was inappropriate for large numbers of joint venturers. See Law Commission and Scottish Law Commission, *Joint Consultation Paper on Partnership Law* (London, 2000), paras 5.51–5.61.
[6] It could be formed as a registered company or as a statutory or chartered one (see below, para.1–26) or indeed as an Open-Ended Investment Company under the Financial Services and Markets Act 2000 (see below, para.1–31). If it was formed as a partnership it would be automatically dissolved for illegality: Partnership Act 1890 s.34.
[7] And contained other provisions designed to restrict limited liability to relatively substantial companies, such as that each of the 25 members had to have subscribed for shares with a nominal value of at least £10, of which 20 per cent had to be paid up.
[8] And removed the capital requirements of the 1855 Act.
[9] *Salomon v Salomon* [1897] A.C. 22. See below, paras 2–1 et seq.
[10] EC Directive 89/667 [1989] O.J. L395/40.
[11] 2006 Act s.7(1)—which is not confined to private companies.
[12] Partnership Act 1890 s.24(5).

http://www.pbookshop.com

introduce for listed companies an additional set of core rules that are not applied to non-listed companies. It has also introduced further sets of rules—Prospectus Rules ("PR") and Disclosure and Transparency Rules ("DTR"). These are heavily driven by the need to transpose EU law in the UK, however, the transposition has had the further impact of shifting some topics from the companies legislation to the FCA's rules.[20] Here it is interesting that Parliament has proceeded with transposition not primarily by way of direct amendment of the FSMA, but by giving the FCA extended rule-making powers. Finally, it was required in the FSMA to produce a Code of Market Conduct ("MAR") to flesh out the meaning of the statutory prohibition on market abuse, which we consider in Ch.30.

3–8 In short, the FCA has power to issue elaborate sets of rules, without the need for formal approval by either Parliament or a Governmental Department.[21] The public interest is protected, however, by the statutory requirement to publish a statement of policy on the imposition of sanctions for breaches of the Rules.[22] Thus, although the FCA is a private company formed under the Companies Act, in fact a company limited by guarantee,[23] and is financed by a levy on those who engage in financial services business, it has extensive public functions and is itself subject to controls thought to be appropriate to a public body.

Financial Reporting Council

3–9 The second area where delegated rule-making is to be found on a substantial scale in the present law is in relation to corporate governance, accounting standards, the accuracy of accounts, auditing standards and the regulation of auditors and accountants. This is an area where the Financial Reporting Council ("FRC") and its various subsidiaries are immensely important. Their functions were much enhanced as a result of reforms implemented in the UK in the wake of the Enron and related scandals in the US,[24] and the impact of their rule-making has grown further as a result of the 2008 financial crisis. These functions are analysed in Chs 21 and 22, and that analysis need not be anticipated here. What needs to be noted, however, is that, like the FCA, the FRC acquires its powers by way of delegation from the Secretary of State (who can therefore re-allocate them).[25] Like the FCA, the FRC and its subsidiaries are companies limited by guarantee, but its directors are appointed by the Secretary of State, so that the FRC, although more expert than a Government Department (and partly financed by those it regulates), is tied into the governmental machinery.

---

[20] Mainly the rules on disclosure on interests in shares on the part of directors and "major" shareholders. See Ch.26.
[21] As ss.73A and 119 of FSMA 2000 contemplate.
[22] FSMA 2000 ss.93–94.
[23] See above, para.1–8.
[24] The main legislative expression of these reforms was the Companies (Audit, Investigation and Community Enterprise) Act 2004, some parts of which have survived the 2006 Act.
[25] 2006 Act ss.457 and 1217 and Sch.10.

Common law

3–10 In spite of the bulk of the Companies Act and its satellite legislation, it does not contain a code of company law. The British Companies Acts have never aspired to lay down all the rules which sustain the core features of company law, as identified in the previous chapter. However, the 2006 Act goes further in that regard than previous Acts. The Law Commissions recommended that there should be a statutory statement of the common law duties of directors (though not of the remedies for breach)[26] and the English Law Commission that the law relating to the enforcement of those duties should be both reformed and stated in legislative form.[27] Both these sets of recommendations were broadly endorsed by the Company Law Review, and were included in the 2006 Act, thus effecting a major extension of statutory company law.[28]

Although these reforms significantly altered the balance between statute law and common law in company law, they may have a much less pronounced effect upon the role of the judges in developing company law. So far as directors' duties are concerned, although the statutory statement largely replaces the existing common law and equitable rules, it is drafted as a relatively "high level" statement. Consequently, the pre-existing case law will remain relevant where the statement simply repeats, rather than reforms, the common law; and recourse throughout the statement to broad standards, rather than precise rules, means the judges will have an important role in developing and applying the standards, just as they have had in respect of those standards which were embodied in statute from the beginning.[29] Indeed, in performing this task, s.170(4) of the 2006 Act specifically, and uniquely for a UK statute, requires that "[t]he general duties shall be interpreted and applied in the same way as common law rules or equitable principles, and regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general duties". As to the enforcement of these statutory directors' duties, the reform creates a greater judicial discretion to allow or refuse derivative actions, so that the judges are, if anything, more important under the Act than the prior common law.

Review and reform

3–11 It is clear that company law consists of a complex and diverse body of rules. Keeping this law under review is now, in the main, the task of the Department of Business, Innovation and Skills ("BIS"),[30] which is the Government Department currently responsible for company and insolvency law, among many other matters. As for financial services law, including public offerings of securities and

---

[26] *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties*, Cm. 4436, 1999.
[27] *Shareholder Remedies*, Cm. 3769, 1997.
[28] See below, Chs 16 and 17.
[29] For example, the unfair prejudice provisions, discussed in Ch.20.
[30] Its predecessors were the Department for Business, Enterprise and Regulatory Reform ("BERR"), and, before that, the Department of Trade and Industry ("DTI"), responsible for the CLR.

The CLR recommended,[13] and the Government accepted and eventually implemented,[14] the re-establishment of a single regime. This is based on a single set of disclosure requirements, derived from the Eleventh Directive, but using a multi-pronged connecting factor. The Overseas Companies Regulations 2009[15] are expressed to apply whenever an overseas company opens an "establishment" in the UK; but "establishment" is defined to mean a branch within the meaning of the Eleventh Directive or a place of business which is not a branch.[16] Thus, either a branch or a place of business will trigger the operation of the provisions relating to overseas companies, but the crucial point is that the disclosure rules will not now vary according to whether the "establishment" test is met on the basis of a branch or a place of business.[17]

Establishment: branch and place of business

6–4

The terms "branch" and "place of business" obviously overlap to a large extent but it seems that both at the top and at the bottom of the spectrum a place of business may exist even though a branch does not. To take the bottom end, this situation may arise because, it seems, activities ancillary to a company's business may constitute a place of business but not a branch. It is difficult to be absolutely certain about this, because the Eleventh Directive does not define a "branch" whilst the Regulations do not define a "place of business", but it seems to be the case. It has been said in case law that establishing a place of business, as opposed to merely doing business, in this country requires "a degree of permanence or recognisability as being a location of the company's business".[18] However, it is not fatal to the establishment of a place of business that the activities carried on there are only subsidiary to the company's main business, which is carried on outside the UK, or are not a substantial part of the company's overall business.[19] As to the meaning of a branch some clues may be derivable from the EU legislation referring to bank branches.[20] This does contain a definition of a bank branch, from which some guidance may be obtainable. That definition refers to a place of business through which the bank "conducts directly some or all of the operations inherent in the business".[21] So it may be that purely ancillary activities, such as warehousing or data processing, do not constitute the

[13] Oversea Companies (1999) and Final Report I, paras 11.21–11.33.

[14] Modernising Company Law, 2002, Cm 5553–1, para.6.17. The havering around the implementation of this policy in the Act itself was described in the 8th edn of this book at pp.122–123.

[15] Overseas Companies Regulations 2009 (SI 2009/1801), as amended.

[16] SI 2009/1801 regs 2, 3, 30 and 68.

[17] However, the trading disclosures requirements apply on an even broader basis: see para.6–6.

[18] [1986] 1 W.L.R. 180 at 184. See also [1990] B.C.L.C. 546.

[19] *South India Shipping Corp v Export-Import Bank of Korea* [1985] 1 W.L.R. 585 CA; *Actiesselskabat Dampskib "Hercules" v Grand Trunk Pacific Railway Co* [1912] 1 K.B. 222 CA. Registration in the UK of an establishment in order to carry on business involves the creation of a place of business, even if business has not yet commenced at the establishment: *Teekay Tankers Ltd v STX Offshore & Shipping Co* [2015] 2 B.C.L.C. 210. However, the business must be the business of the company, not of its agent or subsidiary: *Rakusens Ltd v Baser Ambalaj Plastik Sanayi Ticaret AS* [2002] 1 B.C.L.C. 104 CA; *Matchnet Plc v William Blair & Co LLC* [2003] 2 B.C.L.C. 195.

[20] This EU legislation is not otherwise dealt with here.

[21] See, for example, Directive 94/19/EC on deposit guarantee schemes, art.1(5).

establishment of a branch though they could amount to a place of business. To like effect is the definition of a branch adopted by the Court of Justice for the purposes of the Brussels Convention: a branch has the appearance of permanency and is physically equipped to negotiate business with third parties directly.[22] At the other end of the spectrum, a company incorporated outside the UK but which has its head office here,[23] clearly has a place of business in the UK, but it might be argued that this is not a branch, since a branch supposes that the head office is elsewhere.[24]

Disclosure obligations

6–5

The Act and the Overseas Companies Regulations impose disclosure requirements on an overseas company having an establishment in the UK in all phases of its life. An overseas company which opens an establishment must file with the Registrar within one month information relating to both itself and the establishment.[25] Subsequent alterations in the registered particulars must also be notified.[26] Failure to do so constitutes a criminal offence on the part of both company and any officer or agent of the company who knowingly and wilfully authorises or permits the default,[27] but, apparently, does not affect the validity of transactions the company may enter into through its unregistered operation. There is no need in a book of this nature to go into the detail of what is required, but it should be noted that the requirements are more limited where the company is incorporated in an EEA Member State than where this is not so.[28] This reflects the approach of the Eleventh Directive.[29] Overall, the policy can be said to be to put the person dealing with the overseas company through its establishment in a similar informational position as would obtain if the company were one incorporated under the Act.

http://www.pbookshop.com

[22] Case 33/78 *Etablissements Somafer v Saar-Ferngas* [1978] E.C.R. 2183.

[23] In principle, British law accepts such an arrangement, though not all European countries do: see paras 6–17 et seq., below.

[24] However, in the *Centros* case (Case C-212/97 [1999] E.C.R. I-1459) the CJEU seems to have treated as a branch, for the purposes of art.49 TFEU, the British company's place of business in Denmark, even though it carried on no business anywhere else, including the UK, which was simply its place of incorporation. Putting the matter the other way around, this might suggest that the British head-office of a company incorporated elsewhere would also be a "branch" for the purposes of the Eleventh Directive.

[25] 2006 Act s.1046 and the Overseas Companies Regulations 2009 Pt 2. The information about the company must include a certified copy of its constitution (reg.8(1)). The residential addresses of directors or permanent representatives are subject to the same protective provisions as in the case of UK-incorporate companies: Pt 4. Although the disclosure obligation applies in principle each time the overseas company opens an establishment in the UK (reg.4(2)), the company need not repeat the company-specific information each time, but simply cross-refer to it (reg.5). This applies even though the establishments are in different UK jurisdictions.

[26] 2009 Regs Pt 3.

[27] 2009 Regs regs 11 and 17.

[28] 2009 Regs reg.6.

[29] cf. arts 2 and 8 of the Eleventh Directive. The theory, presumably, is that the more extensive information about the company is available from the national registries of EU Member States, under the provisions of the First Directive.

obligations he caused the company to insure against liability to pay compensation under the Workmen's Compensation Act. He was killed in a flying accident. The Court of Appeal of New Zealand held that his widow was not entitled to compensation from the company (i.e. from their insurers) since Lee could not be regarded as a "worker" within the meaning of the Act. But the Privy Council reversed that decision, holding that Lee and his company were distinct legal entities which had entered into contractual relationships under which he became, qua chief pilot, an employee of the company. In his capacity of governing director he could, on behalf of the company, give himself orders in his other capacity of pilot, and hence the relationship between himself, as pilot, and the company was that of servant and master. In effect the magic of corporate personality enabled him to be master and servant at the same time and to get all the advantages of both (and of limited liability). No doubt the court was influenced by the fact that Lee had acted in pursuance of a purported statutory obligation and had in fact paid the necessary contributions over a period of time, thus forgoing the opportunity of making alternative insurance arrangements. More recent cases in Britain have accepted that in principle a person who is a 100 per cent shareholder in a company may enter into a valid contract of employment with that company, even though that person also appears, in effect, on the other side of the employer/employee relationship, so that the control element, normally inherent in the employment contract, is missing.[31]

At common law

8–10 Challenges to the doctrines of separate legal personality and limited liability at common law tend to raise more fundamental questions, because they are formulated on the basis of general reasons for not applying them, such as fraud, the company being a "sham" or "façade", that the company is the agent of the shareholder, that the companies are part of a "single economic unit" or even that the "interests of justice" require this result. However, the courts seem, if anything, more reluctant to accept such general arguments against the doctrines than arguments based on particular statutes or the terms of particular contracts. The decision of the House of Lords in *Salomon v A Salomon and Co Ltd*,[32] where the court refused to hold the sole owner of the company's shares liable for its debts, has stood the test of time. The leading modern case is *Adams v Cape Industries Plc*.[33] That case raised the issues in a sharp fashion. It concerned liability within a group of companies and the purpose of the claim was to circumvent the separate legal personality of the subsidiary in order to make the parent liable for the obligations of the subsidiary towards involuntary tort victims. Thus, the case encapsulated two features—internal group liability and involuntary creditors—where limited liability is most questionable. The facts of the case were somewhat complicated but for present purposes it suffices to say that what the Court had ultimately to determine was whether judgments obtained

[31] *Neufeld v Secretary of State for Business, Enterprise and Regulatory Reform* [2009] 2 B.C.L.C. 273 CA.
[32] *Salomon v A Salomon and Co Ltd* [1897] A.C. 22; see para.2–1, above.
[33] *Adams v Cape Industries Plc* [1990] Ch. 433, Scott J and CA (pet. dis. [1990] 2 W.L.R. 786 HL).

in the US against Cape, an English registered company whose business was mining asbestos in South Africa and marketing it worldwide, would be recognised and enforced by the English courts. In the absence of submission to the foreign jurisdiction on the part of Cape, this depended on whether Cape could be said to have been "present" in the US. On the facts, the answer to that question turned on whether Cape could be said to be present in the US through its wholly owned subsidiaries or through a company (CPC) with which it had close business links. The court rejected all the arguments by which it was sought to make Cape liable.[34]

The "single economic unit" argument

8–11 The first of these, described as the "single economic unit argument", proceeded as follows: Admittedly there is no general principle that all companies in a group of companies are to be regarded as one; on the contrary, the fundamental principle is unquestionably that "each company in a group of companies is a separate legal entity possessed of separate rights and liabilities".[35] Nevertheless, it was argued that, where the group companies are operated as a single unit for business purposes, the court will ignore the distinction between them, treating them as one. For this proposition a number of authorities were cited, but the court distinguished them all as turning on the interpretation of particular statutory or contractual provisions.[36] After reviewing these authorities the Court in *Cape* expressed some sympathy with the claimants' submissions and agreed that:

> "To the layman at least the distinction between the case where a company trades itself in a foreign country and the case where it trades in a foreign country through a subsidiary, whose activities it has power to control, may seem a slender one."[37]

[34] Note, however, the alternative legal approach to the problem, by-passing the separate legal personality issue by postulating a duty owed in tort by the parent company directly to the asbestos victims (the employees of the subsidiary): *Connelly v RTZ Corp Plc* [1998] A.C. 854 HL; *Lubbe v Cape Plc* [2000] 1 W.L.R. 1545 HL; *Chandler v Cape Plc* [2012] EWCA Civ 525. Doctrinally, this approach leaves the separate legal personality and limited liability concepts intact within groups but in fact imposes liability on the parent towards tort victims of subsidiaries. Whether a duty of care will be imposed on the parent turns on the degree of control exercised by the parent over the relevant activities of the subsidiary. If developed extensively, the tort doctrine could in practice remove limited liability within groups in relation to tort victims, not necessarily a matter of regret since limited liability is most questionable in relation to non-adjusting creditors. However, to date the courts have been cautious: for the parent company simply to appoint the directors of the subsidiary will not attract liability to the parent nor will running the subsidiaries as a division of the parent, if the separate legal personalities of the companies are respected: *Thompson v The Renwick Group Plc* [2014] 2 B.C.L.C 97 CA.
[35] *Adams v Cape Industries Plc* [1990] Ch. 433 at 532; quoting Roskill LJ in *The Albazero* [1977] A.C. 744 CA and HL at 807.
[36] *The Roberta* (1937) 58 L.L.R. 159; *Holdsworth & Co v Caddies* [1955] 1 W.L.R 352 HL; *Scottish Co-operative Wholesale Society Ltd v Meyer* [1959] A.C. 324 HL (Sc.); *DHN Food Distributors Ltd v Tower Hamlets LBC* [1976] 1 W.L.R. 852 CA (probably the strongest case in the tort victims' favour, because it was strongly arguable that the court there did not base itself on the particular statutory provision but on a more general approach founded on the idea of single economic entity); *Revlon Inc v Cripp & Lee Ltd* [1980] F.S.R. 85; and the Opinion of the Advocate General in Cases 6 and 7/73 [1974] E.C.R. 223.
[37] *Adams v Cape Industries Plc* [1990] Ch. 433 at 536B.

http://www.pbookshop.com

CHAPTER 12

DIVIDENDS AND DISTRIBUTIONS

The Basic Rules **12–1**
Public and private companies **12–2**
Identifying the Amount Available for Distribution. **12–5**
Interim and initial accounts **12–6**
Interim dividends. **12–7**
Adverse developments subsequent to the accounts **12–8**
Disguised Distributions **12–9**
Intra-group transfers **12–11**
Consequences of Unlawful Distributions **12–12**
Recovery from members **12–12**
Recovery from directors **12–13**
Reform **12–15**
The central issues. **12–16**

THE BASIC RULES

12–1 The rules on legal capital, discussed in the previous chapter, have their main impact on companies through their role in setting the maximum amount payable by way of dividend or other form of distribution to shareholders. Whether the company chooses to make the maximum distribution permitted by the distribution rules is, in most circumstances, a matter for it. Where a company has substantial distributable profits, it will often not pay them all out to the shareholders but will keep some for re-investment. The legal rules have their bite where the company does in fact hold enough cash to pay a dividend but the rules to be discussed in this chapter prevent a distribution at the level the company would otherwise desire.

The distributions rules discussed in this chapter are aimed at protecting creditors. This will be our main focus. However, there may also be shareholder/board conflicts over the level of distributions, managers perhaps preferring to re-invest surplus cash in the business, the shareholders preferring cash in hand.[1] The respective roles of the board and the shareholders in determining the level of dividend are left to be determined in the articles of association (subject, of course, to the constraints imposed by the creditor protection rules). The model articles for private and public companies limited by

[1] Theoretically, it is far from clear that there is a real conflict here. If management retains earnings to invest in good projects, which the market evaluates appropriately, then the company's share price will rise and a shareholder seeking income can sell part of the (now more valuable) shareholding. So, the issue is simply the form of the income: dividend or capital gain. But investors may not trust managers to make good investment decisions or may have different time-frames from the managers for realisation of their investments.

http://www.pbookshop.com

competence. Allowing unanimous shareholder consent to override the articles would further emphasise the primacy of shareholders as against the directors. Shareholders would be able to tell the directors what to do, even within the area of competence granted by the articles to the board, provided only they acted unanimously. As against this, however, even if it is conceded that the shareholders acting unanimously are competent to act, the shareholders are not subject to the same duties as directors, so the risk is then that stakeholders other than the shareholders, perhaps especially the creditors, will not be protected from adverse corporate decisions in the same way that they are when those decisions are taken by the board. Of course, since the shareholders have statutory power to dismiss directors, as discussed below, this theoretical conflict seems quite unlikely to emerge in practice.

The mandatory involvement of shareholders in corporate decisions

14–18 Despite the flexibility which British company law gives the company to divide decision-making powers between shareholders and the board, there are a number of situations where the legislation requires shareholder approval of the board's decision (and sometimes even permits the shareholders to initiate a decision). The main category of such cases is where decision is likely to have an impact upon the shareholders' legal or contractual rights, even if the practical impact of that change on the member in a particular case is small (as with many changes to the articles). Without giving an exhaustive list of such situations, the following can be said to constitute the main examples of this policy:

- alterations to the company's articles[39];
- alteration of the type of company, for example, from public to private or vice versa[40];
- decisions to issue shares[41] or to disapply pre-emption rights on issuance[42];
- decisions to reduce share capital, re-purchase shares; redeem or re-purchase shares out of capital in the case of private companies or give financial assistance in the case of private companies[43];
- alterations to the class rights attached to shares[44];
- adoption of schemes of arrangement[45];
- decisions to wind the company up voluntarily.[46]

All these provisions place limits on the extent to which the articles may authorise the board to proceed solely on its own initiative. They probably reflect the view that shareholder interests are potentially involved in such decisions, that

[39] As discussed in Ch.3, above. The adoption of the initial constitution is also an act of the shareholders, since the incorporators become members of the company: above, para.4–5.
[40] Discussed in Ch.4, above.
[41] 2006 Act s.549 (below, Ch.24).
[42] 2006 Act ss.569 et seq. (below, Ch.24).
[43] All these matters are discussed in Ch.12, above.
[44] 2006 Act ss.630 et seq., discussed below in Ch.19.
[45] 2006 Act ss.895 et seq., discussed below in Ch.29.
[46] Insolvency Act 1986 s.84.

http://www.pbookshop.com

shareholders are probably as well-equipped to take the decisions as the board, and that they are not decisions which occur frequently in the life of the company, but, beyond that, the provisions do not contribute directly to the development of good corporate governance.

14–19 There are, however, four further cases where contributing directly to good corporate governance underpins the requirement of shareholder approval of:

- the appointment of the company's auditors[47];
- certain transactions entered into by directors or their associates with their company[48];
- ratification of the taking by directors of corporate opportunities[49];
- defensive measures to be taken once a takeover offer is imminent—a requirement contained in the rules of the City Code on Takeovers and Mergers, with those rules now having statutory force.[50]

The first of these requirements is designed to promote the independence of the company's auditors from its management (though it is far from clear that it always successful in doing so) and the others deal with conflicts of interest between the director and his or her company.

14–20 Finally, the Listing Rules, which apply to Premium Listed companies quoted on the London Stock Exchange, introduce a third basis for shareholder approval, namely the size of the transaction. Under those Rules, significant transactions (both acquisitions and disposals) which meet the test of being either "Class 1" transactions or "reverse takeovers" require shareholder approval. In brief, the Class 1 criteria are met if any one of four financial ratios which compare the size of the transaction with the size of the company is 25 per cent or more; and an acquisition is a reverse takeover if any of the ratios is 100 per cent or more, or if the transaction would result in a fundamental change in the company's business, board composition or voting control. The financial ratios relate to the company's gross assets, profits, consideration and gross capital.[51] The thought behind the provisions seems to be that a big transaction is as much like an investment decision as a management decision, and so the shareholders are to be involved in the taking of the decision, along with the management. This ground for insisting on shareholder involvement in a decision has no counterpart in the Act.

The mandatory functions of the directors

14–21 Just as the Act requires shareholders to be involved in some corporate decisions, so, scattered throughout the Act, are functions which are imposed on the directors of companies and which therefore may not be given to the shareholders. It would

[47] 2006 Act Pt 16, Ch.2, discussed below at paras 22–7 et seq.
[48] 2006 Act Pt 10, Ch.3, discussed below at paras 16–67 et seq.
[49] Discussed below at paras 16–117 et seq. See also the mandatory role of shareholders on board remuneration: below at paras 14–30 et seq.
[50] See paras 28–20 et seq.
[51] LR 10. The FCA has the power to dispense from the strict application of this rule.

not deprive the nominating shareholder of his or her right to the same information.[135] The fact that the provisions are mandatory as against the company and increase, at least marginally, the company's costs in relation to the circulation of information was a strong argument in the Government's eyes against introducing them, and the provisions are crafted so far as possible to reduce those costs. Those costs are confined to the largest companies because the provisions, at present, apply only to companies listed on a regulated market.[136] However, there are a number of other provisions which aim to cut down the cost implications of the new rule, even for these large companies.

First, the right to nominate a recipient of information rights is restricted to those members who hold shares on behalf of another person and where the recipient is that other person.[137] Secondly, the only rights which may thus be conferred are "information rights", i.e. essentially the right to receive the communications which a company sends to its members (including its annual accounts and reports) or any class of them which includes the nominating shareholder.[138] No other governance rights may be transferred compulsorily as against the company. Thirdly, a company need not accept the conferment of only some of the shareholder's information rights.[139] The company can thus insist on an "all or nothing" conferment of information rights. Fourthly, unless the shareholder, on behalf of the nominated person, requests circulation in hard copy and provides the company with an address, the company may meet its obligation to the nominated person through website publication.[140] Fifthly, all nominations are suspended when there are more nominations in force than the nominator has shares in the company, so that the burden of sorting out the errors is moved away from the company.[141] Sixthly, the company may enquire of a nominated person once every 12 months whether it wishes to retain information rights and the nomination will cease if the company does not receive a positive response within 28 days. Seventhly, to relieve the company of the burden of staying on top of things, if the nomination is terminated or suspended for any reason,[142] the company may continue to abide by it "to such extent or for such period as it

[135] 2006 Act s.150(5)(a).

[136] 2006 Act s.146(1). That regulated market may be located in any Member State but the company must be one subject to the domestic companies legislation. In other words, a company registered in any jurisdiction of the UK will not escape this obligation by listing on a regulated market in, for example, France or Germany, but a company incorporated in Germany and listed on a regulated market in the UK will not be subject to the obligation.

[137] 2006 Act s.146(2). As we saw above, s.145 is not restricted in this way, though the articles are most likely to provide for transfers of rights in such a case.

[138] 2006 Act s.146(3)(a),(4). Rights to require copies of the accounts and reports or to require hard copies of documents are also included within the notion of "information rights": s.146(3)(b).

[139] 2006 Act s.146(5).

[140] 2006 Act s.147. The right to request hard copy will also give way if the company has adopted electronic communication as its way of communicating with its members generally: s.147(4) and see below, para.15–85.

[141] 2006 Act s.148(6). Section 148(7) deals with the class right variation of this problem.

[142] Besides the two situations just described, the nomination will be terminated at the request of the member or nominated person, and will cease to have effect on the death or bankruptcy of an individual or the dissolution or the making of a winding-up order of a corporate shareholder: s.148(2)–(4).

thinks fit".[143] Eighthly, the rights conferred upon the nominated person are enforceable only by the member, the rights to be treated for this purpose as if they were conferred by the company's articles.[144]

The right to enjoy information rights is thus, it may be said, rather grudgingly conferred. The main non-restrictive provision is the one which tracks s.145 and provides that any enactment or anything in the company's articles relating to communications with members has corresponding effect in relation to communications with nominated persons.[145]

15–41 The compulsory information provisions discussed above do not in any way touch on the relationship between the nominated person and the member after the information has been received. As we have seen above, the nominated person, having received notice of a meeting, for example, has power to instruct the member how to vote, if the member holds the share on a bare trust for the nominated person.[146] But there is no legal obligation upon the member, in this case or more generally, to seek the views of the nominated person before voting, in the absence of an instruction, contrary to the position in some other legal systems. Such an obligation may be created by contract, however, either between the nominated person and the member or, conceivably, between the company and the member. This is then a governance issue, as discussed earlier.

THE MECHANICS OF MEETINGS

15–42 We turn now to the various issues arising where a meeting is sought to be held, so that resolutions of the shareholders can be voted upon. This is the only method s.281 provides for the adoption of resolutions by public companies and it is open to private companies to use it instead of the written resolution method, which it may wish to do where it has a large shareholding body. These issues appear in their sharpest form where a group of shareholders wish to use the shareholders' meeting to challenge some aspect of the management of the incumbent directors. Therefore, we shall generally adopt this perspective in our analysis of the rules, though, of course, those rules may also be relevant in the more usual case where the meeting is called by the board to discuss a matter which the shareholders find relatively uncontentious.

What happens at meetings?

15–43 It is a rare shareholders' meeting which does not end up passing a resolution on some matter or another. As we saw in Ch.14, the Act requires the shareholders' consent before certain decisions can bind the company, and the articles may add to that list. By assenting to a resolution the shareholders give the consent which is necessary to make the act an act of the company. Once the shareholders have adopted an effective resolution on a particular matter, the board is empowered,

[143] 2006 Act s.148(8).

[144] 2006 Act s.150(2).

[145] 2006 Act s.150(3)—and even that provision is subject to qualifications in s.150(4).

[146] Above, fn.108.

http://www.pbookshop.com

The Court of Appeal allowed the appeal (Briggs LJ dissenting),[129] distinguishing previous cases of improper purposes on three overlapping grounds[130]: that here the purported "victim" was a "victim of his own choice, not a victim of any improper use of a power of the board of directors" since it was his choice how to respond to the questions properly raised[131]; that since no restrictive purposes had been expressed in the statute or the articles, none should be implied unless that was necessary to their efficacy; and, in any event, a restricted proper purpose test would essentially frustrate the purpose or utility of the provisions in question. Although the Court of Appeal did not put it so strongly, their expansive approach could essentially denude the proper purposes doctrine of any substantive role whenever a power was expressed in wide terms—as powers typically are. The Supreme Court disagreed, holding unanimously that the proper purpose doctrine had a central role to play in controlling the exercise of power by directors. But they too provided little guidance as to how these "proper purposes" should be discovered. Lord Sumption SCJ, with whom the other judges agreed, suggested that the relevant improper purposes would "usually [be] obvious from [the] context", and should be inferred from the "mischief" which might follow from exercise of the power.[132]

16–28 That is not much to go on, but, taking the cases together, perhaps two broad categories of "improper purpose" can be identified as operating quite generally, even when powers are expressed in the widest possible terms: use of a power for the purpose of "feathering the director's nest" (these are the easy cases) or for influencing the outcome of existing constitutional balances of power in the company (the harder cases) will typically be regarded as improper.[133] Note that it is not the incidental, or even inevitable, delivery of these ends which is outlawed; many perfectly proper actions by directors will deliver such results. Rather, it is this being the motivation for the exercise of the power, where that motivation has been deemed improper. But even this is not the end of the analysis; there is a further question.

When is a power exercised for improper purposes?

16–29 Directors are rarely actuated by a single purpose. This was true in the *Howard Smith* case, where the company did have a genuine need for fresh capital. If the directors are motivated by a variety of purposes, some proper and some improper, how should the courts determine whether the exercise of power is tainted? Section 171(b) indicates that a director must "only exercise powers for the purposes for which they are conferred". This suggests that *any* improper

[129] *Eclairs Group Ltd v JKX Oil & Gas Plc* [2014] EWCA Civ 640.

[130] As summarised by Lord Sumption SCJ at [2015] UKSC 71 at [28].

[131] *Eclairs Group Ltd v JKX Oil & Gas Plc* [2014] EWCA Civ 640 at [136].

[132] *Eclairs Group Ltd v JKX Oil & Gas Plc* [2015] UKSC 71 at [31] and [30] respectively. For earlier academic considerations, see Completing, para.3.14; and R.C. Nolan, "The Proper Purpose Doctrine and Company Directors" in B. Rider (ed.), *The Realm of Company Law* (Kluwer Law International, 1998).

[133] In the same vein, it would be improper for a director to act for the purpose of favouring his or her nominator, with the cases again suggesting, if only by inference, that a "but for" test is appropriate: see, e.g. *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1991] 1 A.C. 187 PC.

motivating purpose will constitute a flaw. Nevertheless, and perhaps for very pragmatic reasons, that has never been the rule applied in the corporate context except where the exercise of power is motivated by the director's dishonesty or self-interest.[134] Otherwise the courts have typically suggested that a decision will be considered flawed only if the proven improper purpose is the "primary" or dominant purpose for the decision,[135] or if the decision would not have been taken "but for" the improper purpose (even if the improper purpose was not the dominant purpose),[136] or perhaps an either/or version of these two tests[137] if it is thought that they are likely to lead to different answers on the facts. Each alternative poses enormous forensic difficulties, since all require proof of matters peculiarly within the minds of the directors and in relation to which the directors' evidence is "likely to be both artificial and defensive".[138] But in *Eclairs Group Ltd v JKX Oil & Gas Plc*, Lord Sumption SCJ (with whom Lord Hope SCJ agreed) put forward a principled preference for the "but for" test[139]:

> "The fundamental point [in selecting the right test], however, is one of principle. The statutory duty of the directors is to exercise their powers 'only' for the purposes for which they are conferred. ... If equity nevertheless allows the decision to stand in some cases, it is not because it condones a minor improper purpose where it would condemn a major one. ... The only rational basis for such a distinction is that some improprieties may not have resulted in an injustice to the interests which equity seeks to protect. Here, we are necessarily in the realm of causation. ... One has to focus on the improper purpose and ask whether the decision would have been made if the directors had not been moved by it. If the answer is that without the improper purpose(s) the decision impugned would never have been made, then it would be irrational to allow it to stand simply because the directors had other, proper considerations in mind as well, to which perhaps they attached greater importance. ... Correspondingly, if there were proper reasons for exercising the power and it would still have been exercised for those reasons even in the absence of improper ones, it is difficult to see why justice should require the decision to be set aside."

However persuasive that might seem, and whatever the practical advantages of a single simple test, the majority of the Supreme Court declined to commit themselves to this as a statement of the law, given that the issues surrounding mixed purposes had not been argued before the Supreme Court.[140] The matter thus remains unsettled. But it is hard to fault the logic that a decision should be held improper only if it would not in fact have been taken the way it was but for

[134] *Eclairs Group Ltd v JKX Oil & Gas Plc* [2015] UKSC 71 at [17] (Lords Sumption and Hodge SCJJ), citing *Mills v Mills* (1938) 60 C.L.R. 150 at 185–186 Aust. HC, where Dixon J indicated the difficulties.

[135] *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] A.C. 821 at 832 PC (Lord Wilberforce).

[136] *Mills v Mills* (1938) 60 C.L.R. 150 at 186 Aust. HC; *Whitehouse v Carlton House Pty* (1987) 162 C.L.R. 285 at 294 Aust. HC: although this interpretation, supported in *Eclairs Group Ltd v JKX Oil & Gas Plc* [2015] UKSC 71 by Lord Sumption SCJ (with whom Lord Hope SCJ agreed) (at [21]–[22]) was doubted by Lord Mance SCJ (with whom Lord Neuberger PSC agreed) (at [53]). See also *Hirsche v Sims* [1894] A.C. 654 PC; *Hindle v John Cotton Ltd* (1919) 56 S.L.T. 625.

[137] *Eclairs Group Ltd v JKX Oil & Gas Plc* [2015] UKSC 71 at [49].

[138] *Eclairs Group Ltd v JKX Oil & Gas Plc* [2015] UKSC 71 at [20] (on the "primary" purpose test), and see too [54] (on both).

[139] *Eclairs Group Ltd v JKX Oil & Gas Plc* [2015] UKSC 71 at [21], but see generally [21]–[23].

[140] Lord Mance SCJ (with whom Lord Neuberger PSC agreed) set out his doubts at [2015] UKSC 71 at [51]–[54].

http://www.pbookshop.com

There is anecdotal evidence that the effect of these provisions of the Act (introduced in 2000) has been to persuade the directors of many companies not to make political donations from corporate funds, rather than to seek to shareholder approval to do so. Of course, wealthy business figures make large donations to political parties, but do so out of their personal wealth, which may be derived from the activities of businesses they control.

CONFLICTS OF INTEREST AND THE USE OF CORPORATE PROPERTY, INFORMATION AND OPPORTUNITY

The scope and functioning of section 175

16–86 Section 175(1) states that "a director must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company".[318] Section 175(7) makes it clear that a conflict of interests includes a conflict of duties. Subject to a restriction in relation to charitable companies,[319] s.175(3) excludes from the scope of the section one central type of situation involving conflict of interest, namely, "a conflict of interest arising in relation to a transaction or arrangement with the company". These self-dealing transactions are covered by s.177, as discussed above, rather than by s.175.[320] However, it should be noted that s.175(3) has the effect of excluding self-dealing transactions even if s.177 does not apply its normal rule of disclosure to the board of the self-dealing transaction in question, for example, decisions on directors' remuneration (s.177(6)(c)). Having excluded self-dealing transactions, s.175 applies, as is expressly stated in s.175(2), "in particular to the exploitation of any property, information or opportunity" of the company. However, this is simply an inclusive assertion: it is important to note that s.175 imposes a general obligation to avoid conflicts of interest. Any conflict situation, not excluded by s.175(3), will fall within its scope, whether or not it involves the exploitation of property, information or opportunity of the company. The example of a person acting as a director of competing companies is discussed below. Deciding whether a situation does indeed involve the necessary conflict is often

[318] Subject to the exception—"not reasonably regarded as likely" to give rise to a conflict—in s.175(4)(a), which parallels the provision in s.177(6)(a). See para.16–60, above.

[319] In the case of charitable companies self-dealing transactions fall within s.175, unless the articles permit the s.175 duty to be disapplied and, even then, the articles may not effect a blanket disapplication but may do so only "in relation to descriptions of transactions or arrangements specified" in the articles (s.181(2)). Thus, for charitable companies, board or shareholder authorisation will be required in many cases for directors' conflicted transactions with the company. The tougher rules for charitable companies are probably based on the premise that monitoring of the directors by the members of a charitable company is generally less effective than in the case of a non-charitable company and that the Charity Commission cannot make up the whole of the monitoring deficit.

[320] The provisions are thus described as "mutually exclusive": *Re Coroin Ltd* [2012] EWHC 2343 (Ch) at [583] (David Richards J).

the most difficult question in this area. If anything, recent developments in the case law seem to have brought an even wider range of situations within the conflicts category.[321]

As with the self-dealing transactions discussed above, the secondary aim of the rules in this area is to identify the appropriate body or bodies to handle the conflict situation on behalf of the company. As with self-dealing transactions, again, the common law rule was shareholder approval.[322] Section 175 introduces, as we shall see, the mechanism of approval by the uninvolved members of the board, as an alternative to shareholder approval. However, unlike s.177 which imposes simply an obligation of disclosure to the board for self-dealing transactions, s.175 requires the board, assuming it wishes to act, to approve the director putting him- or herself in a position of conflict of duty and interest. This difference in the roles of the board is necessary because, unlike with self-dealing transactions, situations falling within s.175 will not necessarily generate a transaction to which the company is party. An example would be where a director diverts a corporate opportunity for personal benefit. The decision for the board thus becomes not whether to enter into the transaction (the typical question in the self-dealing case), but whether to approve what would otherwise be the director's breach of duty. Nevertheless, the statute has clearly made it easier for directors to obtain approval for the exploitation of a conflict personally, by permitting the non-involved members of the board to give approval (subject to safeguards).

There are two crucial questions to be answered in the area of corporate opportunities: first, how does the law identify an opportunity as a "conflicted" one and, secondly, what processes does it specify for the company to give authority for the taking of the corporate opportunity by the director personally? The statute deals with the second issue in part but with the first issue hardly at all, where reliance is placed on the common law. We look at each of these two issues in turn.

A strict approach to conflicts of interest

16–87 The reason for depriving a director of a profit made from unauthorised exploitation of a corporate opportunity is not an objection to directors making profits as a result of or in connection with or whilst holding their office, but rather that the prospect of a personal profit may make the director careless about promoting the company's interest in taking the opportunity. If taking the opportunity personally does not involve any conflict with the interests of the company, there is no reason to deprive the director of his or her profit. It follows that some of the prior case law on corporate opportunity, which seemed to be based on a free-standing "no profit" rule, is to be regarded with caution under the

[321] Notably *Bhullar v Bhullar* [2003] 2 B.C.L.C. 241 CA; and *Allied Business and Financial Consultants Ltd v Shanahan* (also known as *O'Donnell v Shanahan*) [2009] EWCA Civ 751; [2009] 2 B.C.L.C. 666 CA. Also see, recently, *Sharma v Sharma* [2013] EWCA Civ 1287; [2014] B.C.C. 73 CA; and *Pennyfeathers Ltd v Pennyfeathers Property Co Ltd* [2013] EWHC 3530 (Ch).

[322] In *Queensland Mines Ltd v Hudson* [1978] 52 A.L.J.R. 379 the Privy Council appeared to accept a board decision as releasing the corporate interest in an opportunity, but in that case the only members of the company were two other companies, each represented on the board of the company in question.

http://www.pbookshop.com

THE GENERAL STATUTORY DERIVATIVE CLAIM

The scope of the statutory derivative claim

The court's gatekeeper role

17–11 The novelty of the general statutory derivative claim, contained in Pt 11 of the 2006 Act, is that it places the gatekeeping decision about whether it is in the interests of the company for litigation to be commenced in any particular case in the hands of the court, i.e. an outsider to the company.[22] True, a shareholder must take the first initiative, but after the claim form has been issued, a shareholder seeking to bring a derivative claim must seek the permission of the court to take any substantive steps in the litigation (other than, in the normal case, informing the company that the claim has been issued and that the shareholder is applying to the court for permission to continue the claim).[23] It was already the case that the court had a role in the early stages of derivative claims at common law, but this was to check that the claimant had standing to sue under the rule in *Foss v Harbottle*.[24] Under the new general derivative claim the court has a broader role, namely, to exercise a constrained discretion to decide whether it is in the best interests of the company for the litigation to be brought. This new procedure has the advantages, on the one hand, that the individual shareholder can easily obtain a decision on the central question (whether it is in the interests of the company for the litigation to be brought), whilst, on the other hand, the individual shareholder's enthusiasm for derivative litigation is subject to the filter of a judge having to be convinced that this particular litigation on behalf of the company is desirable.

17–12 Whilst it is true that many of the policy issues which underlay the rule in *Foss v Harbottle* reappear under the statutory procedure,[25] they appear now not as absolute bars to a derivative claim, but as factors the court must take into account in deciding whether to allow the litigation to proceed. Thus, a claimant who is turned away by the court will receive a judgment explaining why a derivative claim in the particular case is not in the company's interests, whereas previously the court's decision said nothing about the desirability of the litigation from the company's point of view, but simply that the litigation decision was a decision for the shareholders generally rather than the individual shareholder.

[22] The earlier history and the purpose of the new statutory derivative claim are considered in *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2011] 1 B.C.L.C. 498 at [73]–[83] (Lewison J).
[23] CPR 19.9(4), 19A(2).
[24] In *Prudential Assurance Co Ltd v Newman Industries Ltd (No.2)* [1982] Ch. 204 CA the court insisted that the question of standing to bring the derivative claim should be decided in advance of and separately from the decision on the merits of the case. This approach is embodied in CPR 19.9. Under this provision the courts recently began to take a broader look at the value to the company of the proposed derivative claim: *Portfolios of Distinction Ltd v Laird* [2004] 2 B.C.L.C. 741 at [51]–[68]; *Airey v Cordell* [2007] B.C.C. 785.
[25] See ss.263 and 268, discussed below.

The types of claims covered by the statutory regime

17–13 There are a good number of limitations to the statutory jurisdiction. The statute applies only to derivative claims or derivative proceedings, i.e. claims brought in respect of a cause of action vested in the company and seeking relief on its behalf.[26] Since the individual shareholder has no power to initiate litigation in the company's name, but the company is to be bound by and is the potential beneficiary of any judgment or order made in the derivative litigation, the Civil Procedure Rules require the company to be made a defendant in the litigation, even though it is the company's rights which are being enforced. Thus, the claim appears in the form of "Shareholder v Director and Company".[27] This can be a cause of confusion, unless it is remembered that the company is only a nominal defendant and that the real defendants are the directors.[28]

17–14 Most derivative claims can now be brought only under the Act,[29] either under the Pt 11 provisions discussed here or as a result of a court order made in unfair prejudice provisions discussed in Ch.20. The rule in *Foss v Harbottle* is thus almost entirely consigned to the dustbin. On the other hand, not all claims a shareholder might want to bring on behalf of the company may be brought under Pt 11 of the Act. The Act contemplates as derivative claims only claims "arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company".[30] Where the company has a cause of action arising in some other way (for example, a claim against a non-directorial employee), the policy seems to be that a derivative claim is not available, and the litigation decision should be taken according to the division of powers contained in the company's articles of association (i.e. normally exclusively by the board). It is only where the directors themselves are in breach of duty that the statutory derivative procedure is available, because that is when the risk of conflicted decision-making by board or shareholders generally arises. However, although the company's cause of action must arise out of breach of duty, etc. by the directors, the defendants are not necessarily limited to and may not even include the directors themselves.[31] We have seen above[32] that third parties may become liable to the company as a result of their involvement in

[26] 2006 Act s.260(1): derivative claims (for England and Wales and Northern Ireland). Section 265(1) provides similarly for derivative proceedings in Scotland. Because of the intimate connection between derivative claims and civil procedure, the Act contains separate provisions for Scotland (ss.265–269) and the rest of the UK (ss.260–264). However, the underlying policies are the same.
[27] CPR 19.9(3). The reason for this oddity seems to be that anyone can make another person a defendant to a claim but making a person a claimant requires that person's consent.
[28] If the shareholder has a personal claim against the directors, the statutory procedure has no application. Personal claims are dealt with below and, as we shall see, there are great complexities about remedies where both the company and the shareholder personally have claims against a director.
[29] The exceptions are those claims against directors falling outside the statutory definition of a derivate claim, in particular multiple derivative claims and claims against foreign registered companies: for the former, see below, para.17–24; for the latter, see *Abouraya v Sigmund* [2014] EWHC 277 (Ch); *Novatrust Ltd v Kea Investments Ltd* [2014] EWHC 4061 (Ch).
[30] 2006 Act ss.260(3) and 265(3).
[31] 2006 Act ss.260(3) and 265(4).
[32] See paras 16–134 et seq.

http://www.pbookshop.com

Companies House. However, an issue immediately arises as to whether the company can effectively be made party to such an agreement, as it would be if the agreement were embodied in the company's articles. Here, there are two apparently conflicting principles: first, that a company, like any other person, cannot with impunity break its contracts and, secondly, that a company cannot contract out of its statutory power under s.21 to alter its articles by special resolution.

The second proposition was favoured by the House of Lords in *Russell v Northern Bank Development Corp Ltd*.[97] It was clear to their lordships that "a provision in a company's articles which restricts its statutory power to alter those articles is invalid"[98] and they applied that principle to the agreement before them, existing outside the articles among the shareholders and to which the company purported to be a party. That agreement provided that no further share capital should be created or issued in the company without the written consent of all the parties to the agreement. Consequently, it would seem that the company cannot validly contract independently of the articles not to alter those articles.[99] However, that proposition is heavily qualified by two further propositions which may render the initial proposition ineffective in practice, at least for those who are well advised.

Prior contracts

19–26 The first qualification is that the principle of invalidity, laid down in *Russell*, does not apply where the company has entered into a previous contract on such terms that for the company to act upon its subsequently altered article would involve in a breach of the prior contract. In this situation the term of the earlier contract which would be breached if the company acted upon the altered article, is not invalid. The *Russell* principle is not relevant here because the term in the earlier contract is not broken when the company alters its articles, but only when it acts upon the altered article. Although the case law has tended to focus on directors' service contracts, its implication for shareholder agreements is that a company would be a party to them and agree not to act in a particular way in the future, provided it did not agree to refrain from amending its articles. Thus, in *Southern Foundries (1926) Ltd v Shirlaw*[100] the company altered its articles so as to introduce a new method of removing directors from office and then used the new method to dismiss the managing director in breach of his 10-year service contract. The managing director successfully obtained damages for wrongful dismissal. The provision as to the term of the service agreement was thus clearly held by the House of Lords to be valid. Lord Porter said: "A company cannot be precluded from altering its articles thereby giving itself power to act upon the provisions of the altered articles—but so to act may nevertheless be a breach of

[97] *Russell v Northern Bank Development Corp Ltd* [1992] 1 W.L.R. 588 HL. See Sealy, [1992] C.L.J. 437; Davenport, (1993) 109 L.Q.R. 553; Riley, (1993) 44 N.I.L.Q. 34; Ferran, [1994] C.L.J. 343.
[98] *Russell v Northern Bank Development Corp Ltd* [1992] 1 W.L.R. 588 at 593.
[99] In this case what was proposed was an increase in the company's authorised capital laid down in the memorandum. Whether the quoted principle applies to all powers conferred on the company by the statute is unclear.
[100] *Southern Foundries (1926) Ltd v Shirlaw* [1940] A.C. 701 HL.

contract if it is contrary to a stipulation in a contract validly made before the alteration".[101] In this case the contract protected a manager but the principle is equally applicable to a contract protecting a shareholder.

19–27 The unresolved issue in relation to this first qualification is whether a claimant seeking to enforce his or her contractual rights against the company is confined to the remedy of damages or whether and, if so, how far, injunctive relief is available to enforce the earlier contract. In *Baily v British Equitable Insurance Co*,[102] the Court of Appeal granted a declaration that to act on the altered article would be a breach of the plaintiff's contractual rights. More surprisingly, in *British Murac Syndicate Ltd v Alperton Rubber Co Ltd*[103] Sargant J went so far as to grant an injunction to restrain an alteration of the articles which would have contravened the plaintiff's contractual rights. Although Sargant J's decision is generally regarded as based upon a misunderstanding of the previous authorities, some sympathy with this approach was expressed by Scott J in the *Cumbria Newspapers* case,[104] where he said that he could "see no reason why [the company] should not, in a suitable case, be injuncted from initiating the calling of a general meeting with a view to the alteration of the articles". To the extent that injunctive relief is made available in this way not simply to restrain acting upon the altered article but to restrain the operation of the machinery for effecting the alteration itself, the notion that the company cannot validly make a direct contract not to alter its articles becomes hollow. Such an extension of injunctive relief would also contradict the dictum of Lord Porter in *Shirlaw*[105]: "Nor can an injunction be granted to prevent the adoption of the new articles". However, injunctive relief merely to prevent the company acting upon the new articles would not fall foul of this principle.

Binding only the shareholders

19–28 The second qualification is that an agreement among the shareholders alone as to how they will exercise the voting rights attached to their shares is not caught by the principle that a company cannot contract out of its statutory powers to alter its articles. This rule was applied to save the agreement in *Russell*, the House of Lords benignly severing the company from the agreement in question. Lord Jauncy said that "shareholders may lawfully agree inter se to exercise their voting rights in a manner which, if it were dictated by the articles, and were thereby binding on the company, would be unlawful".[106] The claimant was granted a declaration as to the validity of the agreement, and it seems that their lordships would have been happy to grant an injunction had the claimant objected

[101] *Southern Foundries (1926) Ltd v Shirlaw* [1940] A.C. 701 at 740–741.
[102] *Baily v British Equitable Insurance Co* [1904] 1 Ch. 373 CA.
[103] *British Murac Syndicate Ltd v Alperton Rubber Co Ltd* [1915] 2 Ch. 186. The case concerned the right of the plaintiff, under both the articles and a separate contract, to appoint two directors to the board so long as he held 5,000 shares in the company. Today, after the *Cumbria Newspaper* decision (see para.19–18, above) the claimant might be protected as the holder of a class right.
[104] *Cumbrian Newspapers Group Ltd v Cumberland and Westmoreland Newspaper and Printing Co Ltd* [1987] Ch. 1 at 24.
[105] *Southern Foundries (1926) Ltd v Shirlaw* [1940] A.C. 701 HL.
[106] *Russell v Northern Bank Development Corp Ltd* [1992] 1 W.L.R. 588 at 593.

http://www.pbookshop.com

the Directive and it means the auditor designated by the audit firm as primarily responsible for carrying out the audit (normally referred to in the UK as the "engagement auditor") but also the auditor who signs the report, if different.[79] In fact, the FRC's rules take up the option to make the rotation rules more demanding and impose a five-year rotation and a five-year gap.[80] In addition, the Regulation requires the phased rotation of all the senior personnel in the audit team.

Rotation of the key audit partner has been required since 2006 Directive,[81] but the Regulation introduces in addition a requirement for the rotation of the audit firm of a PIE. The argument against mandatory rotation of firms is that it means the loss of the expertise of the whole of the existing audit team, which occurrence would be likely to reduce the quality of the audits immediately following a change of firm (unless, of course, the audit team simply changed firms, thus defeating the object of the exercise). In its 2011 proposals for an Audit Regulation the Commission put forward, nevertheless, a rule requiring for PIEs rotation of the audit firm every six years (or a little longer in some cases).[82] As enacted, the firm rotation proposal survived but with considerably longer intervals. The provisions are complex, reflecting their heavy negotiation in the EU's legislative process. In principle, rotation of the firm is required every ten years, but Member States may opt for a 20-year rule, as the UK has done, provided a public re-tendering process is carried out after ten years.[83]

Firm rotation can be looked at as a competition issues as well as an independence issue. Since a mere four firms dominate the global accounting market, choice for large companies is necessarily limited. In an attempt to address this issue, the Competition and Markets Authority made an order in 2014 requiring mandatory re-tendering of audit engagements at least every ten years for the largest 350 companies on the Main Market of the London Stock Exchange.[84] The aim was to give second-tier audit firms an opportunity to break into the market for the provision of audit services to this class of company and to make it worthwhile for those firms to gear up to provide the audit services. The Regulation now goes further than the order in that it requires a change of auditor after 20 years, not just a re-tendering process, and matches the order's requirement of re-tendering within the first ten years.

[79] Regulation art.2(16), apparently translated in the Act as "senior statutory auditor": s.504.
[80] FRC, *Ethical Standards*, para.3.10.
[81] 2006 Act Sch.10 para.10c(1) reflects the original Directive requirements but note para.10(1A) requiring compliance with the stricter rules of the FRC, taking up an option under the Regulation.
[82] Above fn.52, para.3.3.3. In 2012 the FRC amended the CGC to recommend that FTSE 350 companies put their audit business out to competitive tender at least every 10 years. In the light of the EU Regulation this recommendation has been removed from the 2016 CGC.
[83] Regulation art.17. The tendering process is governed by art.16. This Member State choice is implemented in the UK by s.491(1A)(1B). Although not absolutely clear from the Regulation, the UK rules allow a re-tendering process to occur after less than ten years and for the incumbent auditors, if successful, to remain for ten years after that process.
[84] The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014.

Both independence and competition goals might be hindered if there were contractual restrictions in place on the choice of auditor. The Regulation renders such clauses "null and void";[85] the Statutory Auditors Regulations treats them as of "no effect".[86]

Auditors becoming prospectively non-independent

22–15 An auditor may have no current relationship with the company which creates a conflict of interest (nor may he or she have a long association with the company as auditor) but there may be an understanding, falling short of a contract, that the auditor will resign in due course and take up a role in the management of the company. Since accountancy skills are much prized in some areas of management, movement from professional practice to management is quite common. Article 22a of the Directive, however, imposes a two-year "cooling off" period between ceasing to be the statutory auditor or key audit partner and the taking up of a "key" management position in a PIE and a one-year period in any other case. The same periods are applied if the new post is as a non-executive director of the client company or a member of its audit committee (without being either a key manager or a non-executive director—a rare situation). This rule too is implemented via ethical standards in the UK.[87]

THE ROLE OF SHAREHOLDERS AND THE AUDIT AUTHORITIES

22–16 The traditional regulatory strategy deployed by the domestic legislation to reinforce auditor independence has been to enhance the role of the shareholders. In many ways this is an obvious strategy. The accounts and reports are statements from the directors to the members and so putting control over those who verify those statements in the hands of the recipients rather than the originators of the statements appears to be an appropriate strategy. The auditor's relationship with the shareholders is underlined by the provision which gives him or her a right to be sent all notices and other communications relating to general meetings, to attend them and to be heard on any part of the business which affects or concerns the auditor.[88] In the case of a private company which takes its decision by written resolution, the right transmogrifies into a simple right to receive the communications relating to the written resolution, but there is no general right to make representations to the shareholders before they decide.[89] This is a pretty ineffective provision—though it needs to be recognised that many private companies will be exempt from audit on grounds of being "small". However, the shareholders have limited opportunities to exercise control, since they meet infrequently, and in addition may face co-ordination problems in large companies

[85] Regulation art.16(6).
[86] Statutory Auditors Regulations reg.12.
[87] Statutory Auditors Regulations Sch.1 para.7; FRC, *Ethical Standards*, paras 2.47 et seq.
[88] 2006 Act s.502(2).
[89] 2006 Act s.502(1).

http://www.pbookshop.com

Public offers and introductions to public markets

25–2 There are two distinct, though usually combined, operations which may take place when a large company seeks to raise finance from the investing public. In the first place, it needs to make its case to those people who may be interested in investing in it by purchasing its securities. As we shall see below, the company may choose among a number of different ways of putting itself before investors. The most heavily regulated of these methods is the public offer of securities, simply because the company addresses its publicity to a wide range of persons who may include the ill-informed and the gullible as well as the experienced and well-informed. When a company makes a public offer of its shares for the first time, that is usually termed an "initial public offering" ("IPO"), and this is often a major event in the life of the company. But it may well make further public offerings at a later stage ("secondary" offers). The document (the "prospectus") through which public offers are made is regulated heavily by the law. From this perspective, the law relating to prospectuses can be viewed as a branch of consumer protection legislation, but concerning a product which is very difficult to evaluate. The value of shares depends heavily upon the future performance of the company and cannot be ascertained, as with a motor car, for example, by visual inspection and a test drive.

It will normally be the case that a company seeking to raise substantial funds from investors will also secure that the securities to be issued will be admitted to trading on a public securities market, such as one of the markets operated by the London Stock Exchange. The reason the company will normally take this extra step is that the willingness of investors to buy its securities will be increased if there is a liquid market upon which those securities can be traded after they have been issued. As we have seen, a shareholder is normally "locked into" the company after the shares have been purchased, in the sense that the investor, short of winding up, cannot require the company to buy back the shares, even at the later prevailing market price, except in the case of some types of redeemable share. Equally, bonds are not normally redeemable at the request of the investor until after some specified period has elapsed and perhaps not before they reach their maturity date. Therefore, a person who wishes to withdraw from an investment will normally be constrained to find another investor willing to purchase the securities. A liquid securities market will facilitate this operation, to the benefit of both investors and the company, which is likely to be able to sell its securities at a higher price if they have access to the liquidity afforded by a public market.

However, the mere admission of securities to trading on an public market also involves putting those securities before the investing public, even if there is no concomitant public offer, since it is now open to the public to acquire the company's securities, this time not directly from the company but from those who already hold them. Hence, there is a strong argument for having the same information disclosure upon admission of securities to a public market as when the company offers its securities directly to the public. The argument is even stronger if, as is usual, both events occur at the same time. However, there is no legal requirement that this should be so. A company may offer its securities to the

public without securing their admission to public market (for example, where it does not expect or want the securities to be traded to any significant degree and so is content to rely on sellers seeking out potential purchasers privately). Or the driving force[1] behind the admission of the securities to the market may be an existing large shareholder (for example, the Government in a de-nationalisation issue) which wishes to liquidate or reduce its holding, but the company does not intend at that time to raise additional finance.

Our main concern in this chapter is with the financing of the company and the public offer of securities as a form of corporate finance. Consequently, the core transaction which we examine is one in which the company both makes a public offer of its shares and, at the same time, secures the admission of the shares to trading on a public market.

Regulatory goals

25–3 We have referred above to the law relating to public offers as consumer law and that is a very strong strand in the thinking of those responsible for the rules in this area. However, it would be wrong to see the regulation as nothing but a form of consumer protection. In fact, scholarship today stresses the function of regulation in this area as a way of promoting "allocative efficiency", that is, of promoting investment on the basis of an accurate understanding of the risk and reward profile of particular projects which the issuance of the shares will finance. This objective furthers the interests not only of investors but of companies and of the economy generally, for effective regulation promotes the allocation of scarce investment resources to the projects with the highest returns. But what sort of regulation will best facilitate the accurate assessment of different projects?

It is conventional in this branch of law to make a distinction between "merit" regulation and disclosure of information. Under the former approach, a regulator permits an offer to be made to the public only if the securities on offer or the company issuing them ("the issuer") pass certain quality tests, whereas the latter simply puts information in the hands of investors and leaves it up to them to make up their own minds about investing. Although the early regulation of public offers (at state level in the US) adopted the merit regulation approach,[2] the disclosure approach has been the predominant one in all jurisdictions since its adoption by federal US law in the great reforms of 1933 and 1934.[3] However, disclosure has never driven out all elements of merit regulation. Although what is required varies from market to market, disclosure is never all that is required. As a Canadian committee once remarked, with heavy irony, "it would be improbable that a securities commission in a disclosure regime would approve a prospectus that said, truthfully, that the promoters of the company intended to abscond with the proceeds of the public offering, or that the company's business enterprise had

[1] Securities cannot be admitted to the official list (see below) without the consent of the issuer (FSMA 2000 s.75(2)), but the impetus for the listing may come from the shareholder.
[2] Often referred to as "blue sky laws" because the securities on offer were backed, it was said, only by the blue sky. The first significant State law in the US seems to have been that of Kansas in 1911.
[3] The Securities Act 1933 and the Securities Exchange Act 1934.

http://www.pbookshop.com

advisers in particular that an ineffective Panel was likely to lead to the transfer of its functions to a statutory regulator.[34] Further, the Panel's relationship with the FSA in particular was placed on a more explicit footing when FSMA was enacted in 2000.[35]

Perhaps the strongest expression of the new policy of giving the Panel statutory sanctions is to be found in s.955 which confers upon the Panel a power to apply to the court (High Court or Court of Session) where a person has contravened or is likely to contravene a requirement imposed by or under a Code rule or has failed to comply with a disclosure requirement under the statutory provisions just discussed. The court may then make such order as it thinks fit to secure compliance with the requirement, which order will be backed by the sanctions for contempt of court. The Panel, no doubt, expects not to have to make use of this new power, just as it has operated effectively in the past without it.

One important question which arises is whether this section will provide an avenue whereby a party can obtain judicial scrutiny of the Panel's or Appeal Board's rulings during the course of the bid. Of course, the decision to apply to the court for an enforcement order is in the hands of the Panel, so that a party cannot trigger the procedure.[36] However, if the Panel does so apply, the question will be whether the courts in this new context will maintain the after-the-event approach which has been adopted for judicial review and simply enforce the Panel's ruling without scrutinising its legality or without scrutinising it rigorously. This may be a more difficult line for the court to take where the court's order is backed by the sanctions for contempt of court than when the Panel's rulings lacked extensive formal sanctions. Further, if the question is raised whether the Panel's ruling is compatible with the Directive, the court would have to consider making a preliminary reference to the Court of Justice of the European Union (with all the delay that implies).

28–10 The statute places at the disposal of the Panel two other important sanctions, relating to compensation and discipline, but they both require adoption by Panel rules in order to be brought into force. Section 954 provides that the rules may confer power on the Panel to order a person to pay such compensation as it thinks just and reasonable if that person is in breach of a rule "the effect of which is to require the payment of money". This power thus falls short of a general remit to require compensation for breaches of the rules, but it covers the situations where in the past the Panel has required monetary payments.[37] The Code now applies this section to those rules which determine the price at which an offer has to be made or the form of the consideration (for example, where cash or a cash alternative is required).[38]

---

34 Thus, in *R. v Takeover Panel, Ex p. Guinness Plc* [1990] 1 Q.B. 146 CA, the bidder agreed to pay £85 million to the shareholders of the target company in order to comply with a ruling of the Panel.

35 See in particular ss.138 and 143 of FSMA 2000. The current provisions are discussed further below.

36 2006 Act s.955(2) makes it clear that only the Panel can so apply and not, for example, the party to the bid which stands to benefit from the Panel's ruling.

37 See fn.17, above, where the company had been in breach of a Code rule requiring the bidder to increase the price offered to the target shareholders because shares had been purchased in the market at that higher price. For the current version of that requirement, see below at para.28–39.

38 Code, *Introduction*, 10(c).

As to discipline, there is a general provision in s.952 that the rules may give the Panel the power to impose sanctions on a person who has acted in breach of the rules or of a direction given by the Panel to secure compliance with the rules (see above). This is the section on which the Panel now bases its disciplinary powers, which are exercised, except in case of agreement with the offender, by the Hearings Committee (with appeal to the Takeover Appeal Board). The Code sets out the Panel's disciplinary powers and they are the established ones of private or public censure, reporting the offender's conduct to another body for that body to take action against the offender if thought appropriate, and triggering the "cold shouldering" of the offender.[39] It is clear that s.952 permits the rules to adopt a wider range of penalties, notably financial penalties of the type available to the FCA. However, where the Panel adopts a sanction of a kind not previously provided for by the Code, it must produce, again following the FCA model, a policy statement with respect to the imposition of that sanction and, in the case of a financial penalty, the amount of the penalty.[40] So far, the Panel has not ventured into this territory.

The "cold shoulder" and criminal sanctions

28–11 Where the Panel reports conduct to a third party, it is up to that regulator (domestic or overseas) or a professional body to decide whether it is appropriate to take further action. The most likely recipient of such a report from the Panel is the FCA. The FCA might conclude that a person who has broken the Takeover Code is also in breach of its obligations under the FCA's rules and impose sanctions upon that person. The persons most obviously within the FCA's scope are those who need its authorisation to carry on their professional activities within the financial services sector. This will cover the principal advisers to bidders and target companies (notably investment banks) but not bidder and target companies themselves or their directors. To deal with this lacuna, a system of FCA-required "cold shouldering" was introduced in FSMA 2000 and is carried forward under the new arrangements. Cold shouldering involves advisers within the scope of the FCA's powers being required not to deal with those who are likely not to observe the Code. In this situation, there is no suggestion that the adviser is in breach of the Code. Indeed, the "cold shoulder" operates generally and covers all those who might act for persons likely not to observe the Code, whether they have acted for that person in the past or not. In this way, the range of the FCA's sanctions is extended to companies and their directors: if they act, or are likely to act, in breach of the Code, they may find that they are denied the facilities of the City of London in relation to takeover bids. The FCA's rules, as contained in its Code of Market Conduct ("MAR"), require firms not to act in connection with transactions to which the Takeover Code applies if they have reasonable grounds to believe that the person in question is not likely to act in

---

39 Code, *Introduction*, 11(b). The Panel may also withdraw or qualify any special status or exemption it has granted the offender, for example, as an "exempt principal trader".

40 2006 Act s.952(2)–(8). For a discussion of the FCA's penalty powers, see above at para.25–41.

http://www.pbookshop.com

consultation arrangement is in place, both bidder and target may need to consult employee representatives on the employment consequences of the bid or of defensive measures.[232]

In the takeover of Cadbury by Kraft in 2009 the bidder unwisely committed itself not to close a factory in the UK which the target management had decided to shut down. Having obtained control, the bidder discovered there were very good reasons for the previous management's decision and reneged on its commitment. This caused a political storm, as a result of which r.19 was amended to deal with "post offer" statements and undertakings, i.e. statements made during an offer about how a party (typically the bidder) intends to act after the end of the offer period. The amendments apply generally to post-offer statements and undertakings, but these will often be given in relation to employment matters in order to defuse employee or public opposition to the bid. The amendments first require the party to be clear whether it is making a statement of intention (r.19.8) or giving an undertaking (r.19.7) about its post-offer conduct. The requirements on intention statements are less demanding than those on undertakings. For intention statements the statement must accurately reflect the party's intentions at the time it is made and be made on reasonable grounds. For 12 months after the offer has closed (or such other period given in the statement), a party intending to depart from its statement must consult the Panel and, having done so, it must publicly announce its change of heart and explain the reasons for it. The intention statement rules recognise that intentions may genuinely change but they impose a form of "comply or explain" rule, first in relation to the Panel and then in relation to the market and public opinion, in an attempt to control opportunistic changes of mind.

The rules on undertakings are, not surprisingly, more robust. The Panel must be consulted in advance of the undertaking being given and the undertaking must be precisely formulated. In particular, qualifications or conditions attached to the undertaking must be capable of objective assessment (ie not be dependent on the subjective judgement of those giving the undertaking). Even if these conditions are met, a person seeking to invoke a condition or qualification post-bid must obtain the Panel's consent. The giver of the undertaking must report periodically to the Panel on progress, or lack of it, towards its implementation, which reports the Panel may publish. If the Panel has doubts about the quality of these reports, it may appoint an independent supervisor to monitor compliance and to report to the Panel. The regulation of intention statements and undertakings was not an easy issue for the Panel, because it required regulation of post-offer behaviour. Once the offer period is over the Panel's role has traditionally been limited, as discussed below, essentially confined to enforcing its rules on when a failed bidder may bid again. It is notable that in extending its regulatory reach the Panel

[232] Information and Consultation of Employees Regulations 2004 (SI 2004/3426) reg.20. The FCA's rules indicate that it will not be market abuse for a company involved in a bid to disclose information to an employee representative in fulfilment of an obligation imposed by the Regulations, provided the information is subject to a confidentiality requirement: MAR 1.4.5(2)(e). Equally, disclosure of inside information to an employee representative will not be a criminal offence on the part of a manager under s.52 of CJA 1993 if the disclosure is "in the proper performance of the functions of his employment", though it might be for the representative to trade on the information or to further disclose it. See C-384/02 *Criminal Proceedings against Gröngaard* [2006] I.R.L.R. 214 ECJ.

did not put in the forefront the use of its new legal powers,[233] but relied instead on the domestic remedies of Panel consultation and approval and disclosure.

Curiously, however, the strongest mechanism for the protection of employee interests may found in the pensions legislation. Where a highly leveraged bid for a target company is successful, the level of risk in the target company increases, including the risk that the company will default on its obligations under an occupational pension scheme. In that situation, the Pensions Regulator has a, still somewhat ill-defined, power to require the bidder to make extraordinary payments into the fund, which the bidder may either do, and so give the pensioners greater financial protection, or refuse to do and decide not to make an offer. The potential power of the Regulator puts the pension scheme trustees in a position to negotiate with the bidder as to the terms upon which they will regard it proper not to seek the Regulator's intervention.[234]

Profit forecasts and valuations

28–63 In the case of an agreed recommended takeover with no rival bidders, no more may need stating than the Code requires. But, in the case of a hostile bid or where there are two or more rival bids, each of the companies involved will probably want to make optimistic profit forecasts about itself[235] and to rubbish those of the others. All profit forecasts are unreliable and those made in a takeover battle more unreliable than usual. Hence, r.28 (with eight sub-rules) lays down stringent conditions about them. In particular, the forecast "must be compiled with due care and consideration by the directors whose sole responsibility it is" but "the financial advisers must satisfy themselves" that it has been so compiled.[236] The assumptions on which the forecast is based must be stated both in the document and in any press release.[237] Except for a bidder's forecast in a pure cash offer, the forecast must be reported on by the auditors or consultant accountants (and sometimes by an independent valuer[238]) and the report sent to the shareholders[239] and, if any subsequent document is sent out, the continued accuracy of the forecast must be confirmed.[240] All this is wholly admirable but the evidence does not suggest that it has made such forecasts significantly more reliable.

[233] See para.28–9, above.

[234] Pensions Act 2004 ss.43–51 ("financial support directions"). The point is that the pension deficit revealed in the accounts may no longer be an accurate indication of the amount of money needed to secure the pension obligations, if the bidder's risk profile changes significantly. A better test might be the amount an insurance company would require to transfer to itself the company's pension obligations. In the case of the takeover of Boots by a private equity bidder in 2007 the trustees negotiated additional payments of £418 million over 10 years into the pension fund: *Financial Times* 25 June 2007, p.6. In the earlier case of WH Smith it appears that a potential bidder decided not to make a bid because of the target's pension fund deficit.

[235] The offeror will not need to do so on a pure cash offer for all the shares; but the target will.

[236] Code r.28.1.

[237] Code r.28.2 (and see the Notes thereto).

[238] Code r.28.3.

[239] Code r.28.4.

[240] Code r.28.5.

http://www.pbookshop.com

REGULATORY CONTROL OF MARKET ABUSE

Background

30–30 So far, we have looked at the criminal prohibitions on insider dealing and market manipulation. We now turn to the practically more important form of control of market abuse, namely, that administered by regulators, which do not require resort to the criminal law and the criminal courts. In fact, with the enactment of the FSMA 2000, the main thrust of the legal rules controlling market abuse, in which term is to be included both insider dealing and market manipulation, shifted from the criminal law to administrative sanctions which have been placed in the hands of the FCA. At this point, the main source of the rules was Pt VIII of FSMA which was used later to transpose the first EU Directive on market abuse,[127] but in significant ways went beyond that Directive. From the beginning the regulatory sanctions were applied to companies as well as to individuals. Moreover, they applied to all those whose actions had an effect on the market, whether they were persons authorised to carry on financial activities or not. They thus applied as much to industrial companies and their directors, for example, as to investment banks and their directors and employees. These statements are true also of the MAR, now the central legal instrument on administrative control.

Part of the reason for the emphasis on administrative penalties from 2000 onwards was that successful deployment of the criminal law on a wide scale against insider dealing and market manipulation proved difficult. Only after the financial crisis of 2007/8 did the FSA/FCA put substantial resources into the enforcement of the relevant criminal laws. Even so, between 2009 and mid-2015 there were only 27 successful prosecutions for insider dealing (about four a year), of which 23 resulted in custodial sentences (in no case for more than four years).[128] The move towards a regime based on administrative penalties was driven by the desire to address two of the obstacles raised by the criminal offences, namely the need to show intention, at least in relation to insider dealing,[129] and the high evidential requirements of the criminal law. Even so, in the 12 years to March 2015 the FSA/FCA issued only 85 "Final Notices" in relation to market abuse, i.e. about seven a year.[130]

However, the proposals which were eventually embodied in the FSMA 2000 proved highly controversial during the parliamentary debates on the Bill, those opposing it claiming that it would infringe rights conferred by art.6 of the European Convention on Human Rights (right to a fair trial).[131] The central claim of the opponents was that the penalty regime proposed by the Government,

[127] Directive 2003/6/EC on insider dealing and market manipulation (market abuse) [2003] OJ L96/16.
[128] Treasury, Bank of England, FCE, above fn.14, Chart 11. In general those convicted were not sophisticated criminals.
[129] As we have seen, in relation to misleading impressions, mens rea is required only in an attenuated form under what is now the Financial Services Act 2012.
[130] Above, fn.128, p.85.
[131] See Joint Committee on Financial Services and Markets, First Report, *Draft Financial Services and Markets Bill*, Vol. I, Session 1998/99, HL 50-I/HC 328-I, pp.61–67 and Annexes C and D; Second Report, HL 66/HC 465, pp.5–10 and Minutes of Evidence, pp.1–27.

although clearly not part of the domestic criminal law, would be classified as criminal by the European Court of Human Rights, whose classification criteria are independent of those used domestically. Without ever conceding the correctness of this claim, the Government nevertheless did make substantial amendments to its proposals in order to promote the fairness of the new regime, the regime being subject in any event to a general fairness test under the European Convention, even if regarded as civil rather than criminal in nature. These amendments involved in particular the elaboration by the then FSA of a Code on Market Abuse in order to give guidance on the scope of the prohibitions, and the creation of rights of appeal to an independent tribunal (now the Upper Tribunal) to be granted to persons penalised by the FCA.[132]

In the aftermath of the financial crisis, the debate turned on its head. Now, it was argued that the market abuse provisions were inadequate. This was an argument advanced at EU level as well as at domestic level. It led to the replacement of the EU Directive by a Regulation on market abuse (MAR). MAR both expanded the scope of the substantive EU laws on market abuse, but also removed the need for domestic transposition of those laws, thus bringing about a major change in the structure of the domestic law. In fact, with regard to the securities markets aspects of market abuse, which are the focus of this chapter, the structural changes were probably more important than the substantive ones. In particular, MAR led to the removal of the FCA's power to make a Code in this area.[133]

Insider dealing

30–31 The definition of insider dealing in MAR is somewhat more simply phrased than under the CJA.

> "For the purposes of this Regulation, insider dealing arises where a person possesses inside information and uses that information by acquiring or disposing of, for its own account or for the account of a third party, directly or indirectly, financial instruments to which that information relates."[134]

As to inside information, as far as trading in corporate securities is concerned, this is:

> "information of a precise nature, which has not been made public, relating, directly or indirectly, to one or more issuers or to one or more financial instruments, and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments"[135]

[132] The Financial Services and Markets Tribunal, the predecessor to the Upper Tribunal, tended to view the penalty proceedings as being criminal in nature for the purposes of the Convention. However, the standard of proof required by the Convention is not necessarily that of "beyond reasonable doubt". The standard will depend, as is the case with the civil burden in domestic law, on the seriousness of the allegation which has to be proved. See *Davidson & Tatham v FSA*, FSM Case No.31; *Parker v FSA* [2006] UKFSM FSM037; *Mohammed v FSA* [2005] UKFSM FSM012.
[133] FCA, above fn.27, para.3.15.
[134] MAR art.8(1).
[135] MAR art.7(1).

http://www.pbookshop.com