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Butterworths Corporate Law Update

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RECENT DEVELOPMENTS

The Kay Review – Final Report

UK Equity Markets and Long-Term decision making

The Kay Review has produced its final wide-ranging report on UK Equity Markets and their impact on the long-term performance and governance of UK quoted companies. This lengthy report (113pp) discusses everything from the structure of shareholdings and the nature of the investment chain to the regulation of the markets and the importance of fiduciary duties.

Amongst the recommendations most relevant to company law and corporate governance are recommendations that:

- the Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance;
- an investors' forum should be established to facilitate collective engagement by investors in UK companies;
- companies should consult their major long-term investors over major board appointments;
- regulatory authorities at EU and domestic level should apply fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions;
- the Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers;

- mandatory IMS (quarterly reporting) obligations should be removed, and high quality, succinct, narrative reporting should be strongly encouraged;
- companies should structure directors' remuneration to relate incentives to sustainable long-term business performance — long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business; and
- the Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register.

It remains to be seen whether and how the Government intends to take forward these recommendations – a response from BIS is expected later this year. The full report, *The Kay Review of UK Equity Markets and Long-Term Decision Making* (July 2012) is available at http://www.bis.gov.uk/assets/biscore/business-law/docs/k/12–917-kay-review-of-equity-markets-final-report.pdf.

Proposed changes to the Takeover Code

Widening the application of the Code

The Takeover Panel has issued consultation papers on: (i) profit forecasts and other matters; (ii) pension scheme trustee issues; and, most significantly, (iii) companies subject to the Takeover Code.

- The proposals with respect to profit forecasts etc. are designed to restructure the current provisions (Rule 28) into a more logical framework consistent with other regulatory requirements, such as the Prospectus Rules and the Listing Rules, and to make more detailed requirements with respect to merger benefits statements which are to be renamed 'quantified financial benefits statements'. It is also proposed that Rule 27 be amended to require an offeror and the offeree company to disclose promptly any material changes in information published in the offer document and the offeree board circular respectively. Instead of disclosure potentially being deferred until the party publishes a subsequent document, the proposal is that disclosure be made promptly by way of an announcement, see PCP 2012/1.
- The proposals with respect to pension scheme trustees were flagged previously in 2011 when the Takeover Code was reviewed post the Cadbury/Kraft takeover. That review resulted in stronger rights for employee representatives of the offeree company with respect to obtaining information on a bid, making their views know, etc, and the proposal is that those provisions of the Code which apply to employee representatives should be extended to the trustees of the offeree company's pension schemes, see PCP 2012/2.
- The most important proposed change is with respect to the companies which are subject to the Takeover Code. Currently, an offer for a public company with a registered office in the UK, the Channel Islands or the

Isle of Man, which is not admitted to trading on a regulated market in the UK, is only subject to the Takeover Code if the company is considered by the Takeover Panel to have its place of central management and control in one of those jurisdictions (the 'residency' requirement).

The proposal is to remove the 'residency' requirement so that the Takeover Code will apply automatically to any offer for a public company incorporated in the UK, Channel Islands or the Isle of Man, regardless of whether its shares are traded on a regulated market, and regardless of whether its central management and control is within one of the jurisdictions.

This proposal would mean that offers for companies admitted to AIM (not a regulated market) would fall in future within the Takeover Code. The Code Committee believes that the proposal is a proportionate measure for ensuring that companies with registered offices in the UK, the Channel Islands or the Isle of Man and in whose securities the public may have invested are subject to a suitable level of independent takeover regulation. It would also provide greater certainty as to which companies are subject to the Takeover Code, see PCP 2012/3.

Comments are invited by 28 September 2012; the consultation papers are available at http://www.thetakeoverpanel.org.uk/consultation/current-consultations.

Sanctions for directors of failed banks

Responsibility and accountability of directors

HM Treasury is consulting on:

- a proposal to introduce a rebuttable presumption that the director of a failed bank is not suitable to be approved by the regulator to hold a position as a senior executive in a bank – this proposal is favoured by the Government. Essentially, this would mean that such a person seeking a further appointment would have to show that he or she was not responsible for, and did not contribute to, the failure of the bank;
- the possibility of introducing criminal sanctions for serious misconduct in the management of a bank. While the consultation document considers the introduction of such criminal sanctions, it also notes that the formulation of an offence (probably based on recklessness) would not be easy or straightforward and that, even once formulated, decisions on whether to investigate and prosecute would be extremely complex, expensive and time-consuming. Given the difficulties already noted in the consultation document, it must be doubtful whether this proposal will be advanced.

Comments are invited by 30 September 2012. See HM Treasury, *Sanctions for the directors of failed banks* (July 2012), available at http://www.hm-treasury.gov.uk/consult_sanctions_directors_banks.htm.

Statutory Instruments

Companies House fees. The Registrar of Companies (Fees) (Companies, Overseas Companies and Limited Liability Partnerships) Regulations 2012, SI 2012/1907 (in force 1 October 2012) reduce certain fees payable to the Registrar of Companies, specifically the electronic incorporation fee reduces from £14 to £13, the Web incorporation fee reduces from £18 to £15 and the annual fee attached to the electronic annual return reduces from £14 to £13. Certain inspection fees are also reduced. SI 2012/1908 makes like-provision for EEIGs and European Companies (SE).

Restructuring of FRC. The Statutory Auditors (Amendment of Companies Act 2006 and Delegation of Functions etc) Order 2012 Order, SI 2012/1741 (in force 2 July 2012) makes provision, in essence, for the transfer of the functions of the Professional Oversight Board with respect to statutory auditors under CA 2006, Part 42 to the Financial Reporting Council Ltd following the restructuring of the FRC.

CASES

Piercing the corporate veil

Court of Appeal rules

The Court of Appeal has given an important ruling recently on the scope of the jurisdiction to pierce the corporate veil.

The claimant company (VTB) had entered into a loan agreement with another company (RAP) which then defaulted on the loan to the tune of about $185m. The claimants were pursuing claims in tort for deceit and unlawful means conspiracy against RAP and its alleged controllers and various jurisdictional issues were central to those proceedings.

Leaving those matters to one side, essentially, the piercing issue involved a plea by the claimant to be allowed to amend the particulars of claim to pierce the corporate veil of RAP and claim for breach of contract against three other defendants (who were alleged to be the controllers of RAP) on the basis that they too were parties to the loan agreement. The question for the court was whether there was a good arguable case for asserting contractual liability on that basis.

The issue is of particular interest because in *Antonio Gramsci Shipping Corp v Stepanovs* [2012] 1 BCLC 561, Burton J had held, controversially, that the puppeteers behind a puppet company could be liable on the puppet's contracts (in that case, a charterparty). At first instance in this case, Arnold J had dismissed such a contractual claim as unsustainable as a matter of law.

The Court of Appeal agreed and, after a lengthy and detailed analysis of the main authorities on piercing the veil, concluded that the position in English law is as follows:

- The court may in an appropriate case pierce a company's corporate veil (the court rejected any suggestion by counsel that there was no such thing as veil piercing) and in doing so substantially identify the company with those in control of it, but no authority supports the proposition that once the veil is pierced, the court either does or can proceed in consequence to hold either that the company was a party to the puppeteers' contract, or vice versa.

- While it is possible for a court, having concluded that it is appropriate to pierce the corporate veil, to make consequential orders, such orders are by way of the exercise by the court of a discretionary jurisdiction to do what is convenient in the circumstances (as in the well-known cases, *Gilford Motor Co v Horne* [1933] Ch 935 and *Jones v Lipman* [1962] 1 All ER 442), they are not to the effect that where a company has been used by an individual to mask his own breach of contract that the court treats the company as itself a party to the contract.
- To suggest that the application of the veil piercing principle to the facts would require the court to find that those behind the company were original additional parties to the contracts entered into by the company is nothing more than an appeal to the court to decide the case on the basis of pure fiction. No authority supports the view that that is something the court might or should do, nor would this be a principled development of the law which the court should adopt.
- The veil piercing cases show that the principle is, in its application, a limited one developed pragmatically for the purposes of providing a practical solution in particular factual circumstances. The authorities do not go to the length of treating the puppet company as other than a legal person that is formerly distinct and separate from the puppeteer and were they to do otherwise they would wrongly be ignoring the principles of *Salomon* (*Salomon v Salomon and Co Ltd* [1897] AC 22). Consistently with that, the authorities do not provide any basis for the proposition that the puppeteer should be regarded as having always been a party to a contract to which it or he plainly was not a party.
- The proposed contractual claim was unsustainable as a matter of law and the appeal was dismissed: *VTB Capital plc v Nutritek International Corp* [2012] EWCA Civ 808, [2012] All ER (D) 147 (Jun); the Supreme Court has granted permission for an appeal.

State-owned corporation

Not only has the Court of Appeal recently considered the law governing piercing the corporate veil, but so has the Privy Council in the different context of state-owned corporations.

On appeal from Jersey, the case concerned a claim by a Delaware corporation, as the assignee of two arbitration awards entered against the Democratic Republic of the Congo (DRC), to enforce those awards against assets (in Jersey) of Gecamines, a DRC state-owned corporation, on the basis, essentially, that it was an organ of the DRC. The lower courts concluded that Gecamines was an organ of the DRC and its assets were answerable for the DRC's debts arising from the two arbitration awards.

The Privy Council has allowed an appeal, finding that the conclusions of the lower courts were not justified.

Lord Mance noted that the appeal raised important issues regarding the position of state-owned corporations and the circumstances, if any, in which they and their assets may be equated with the State and its assets. In this case, the issue arose in a claim to hold a state-owned corporation liable for the State's debts, but equally the claim could be to hold a State liable for its state-owned corporation's debts.

Essentially, there were two issues to be decided: whether a company which is state-owned is a separate legal entity or to be regarded as an emanation of the State; and secondly, if it is accepted as a separate juridical entity, whether the corporate veil should be pierced to allow a creditor to pursue the company as well as the State.

On the first issue, the position was that constitutional and factual control and the exercise of sovereign functions do not without more convert a separate entity into an organ of the State. Lord Mance went on to say that, especially where a separate juridical entity is formed by the State for what are on the face of it commercial or industrial purposes with its own management and budget, the strong presumption is that its separate corporate status should be respected and that it and the State forming it should not have to bear each other's liabilities. It will take, he noted, quite extreme circumstances to displace this presumption as where, despite its juridical personality, the entity has no effective separate existence and the affairs of the entity and the State are so closely intertwined and confused that the entity could not properly be regarded for any significant purpose as distinct from the State and vice versa.

Gecamines was not a sham entity, it was a real and functioning corporate entity having substantial assets and a substantial business and there was no justification for concluding that Gecamines and the State should be assimilated for the purpose of allowing all its assets to be available to meet State debts.

The Board agreed that there may be particular circumstances in which the State has so interfered with or behaved towards a state-owned entity that it would be appropriate to lift the veil of incorporation. But any remedy should in that event be tailored to meet the particular circumstances and need, as is the position under domestic law. Merely because the State's conduct makes it appropriate to lift the corporate veil to enable a third party or creditor of the state-owned corporation to look to the State does not automatically entitle a creditor of the State to look to the state-owned corporation.

Even assuming a scenario where State use of Gecamines' assets might conceivably justify a claim to pierce the corporate veil to make the State liable for Gecamines' debts, there was no basis for treating the State's use of Gecamines' assets as a justification for imposing on Gecamines responsibility for the whole of the debts of the DRC.

In international law as in domestic law, Lord Mance said, lifting the corporate veil must be a tailored remedy, fitted to the circumstances giving rise to it: *La Generale des Carrieres et des Mines v FG Hemisphere Associates LLC* [2012] UKPC 27, [2012] All ER (D) 218 (Jul), PC.

Duties of fidelity and fiduciary duties

Employees and company directors

In an interesting and helpful judgment, the Court of Appeal has considered the obligations of fidelity of an employee as compared to the fiduciary duty of loyalty of a company director.

The case concerned an appeal by an employee against a decision that he had breached a contractual obligation of fidelity and a fiduciary duty of loyalty to his employer in his contacts with potential clients for his new business. His contract did not contain any relevant restrictions on his activities after he left his employer.

The Court of Appeal held:

- a distinction must be drawn between company directors and employees. A director stands in a fiduciary relationship to the company, but an employee does not, merely by reason of his role, assume fiduciary obligations to his employer. It is undisputed, however, that an employee has an obligation of fidelity to his employer, if not express, then it will be implied.
- The starting point for determining whether an employee owes fiduciary duties to his employer is his contract of employment and an analysis of the employee's contractual obligations is also an essential foundation for determining the content of the employee's duty of fidelity.
- A fiduciary's single-minded duty of loyalty is a duty to act in the interests of another (in the case of a director, in the interests of the company) whereas an employee's obligation of loyalty is no more than an obligation loyally to carry out the job the employee has agreed to do.
- An employee is not bound to inform his employer when he is doing outside work in breach of contract (unless obliged to do so by the terms of his contract of employment); even in the context of the fiduciary duties of a company director, there is no freestanding duty on the director to inform the company of his own wrongdoing.

In this instance, the trial judge directed himself by reference to cases dealing with directors' fiduciary breaches — an approach liable to lead to confusion, Lewison LJ said — and he had not referred to the terms of the employee's contract of employment. Accordingly, his analysis of the law had got off on the wrong foot.

On the facts, the employee did not owe any fiduciary duty to his employer and his conduct had not amounted to a breach of his contract of employment. The appeal was allowed: *Customer Systems Plc v Ranson* [2012] EWCA Civ 841, [2012] All ER (D) 186 (Jun), [2012] IRLR 769.

Unfairly prejudicial conduct

Petition in respect of an insolvent company

The Court of Appeal has reversed a lower court ruling on an unfairly prejudicial petition (CA 2006, s 994) where the lower court had concluded, inter alia, that excessive remuneration drawn by the respondent majority shareholder and sole director did not amount to unfairly prejudicial conduct when the minority shareholder could have, but had not, obtained copies of the company's accounts from Companies House with the result that the remuneration had gone unchallenged.

Unsurprisingly, Arden LJ rejected that approach noting that the judge's view would mean that minority shareholders would be at risk of losing their rights if they did not read their company's filed accounts, an approach, she said, which imposes on the shareholders a requirement for diligence that has no basis in the statutory provisions or in principle or authority. In any event, at first instance, the court had found that, in fixing his remuneration, the director had had regard to his personal interests rather than the interests of the company and so had acted in breach of his duties to the company, itself a separate basis for a finding of unfairly prejudicial conduct.

The Court of Appeal found unfairly prejudicial conduct also in that the respondent permitted another business of his to use the company's trading name for a period of three years for no payment and he had sold the company's name and goodwill to that other business on the eve of the company going into liquidation at a price which reflected the liquidation costs rather than the best interests of the company.

The additional complication in this petition was that the company was in insolvent liquidation which means that, in general, a petitioner must show that his shares would have had a value but for the wrongdoing of the respondents, i.e. that there is a potential surplus.

Arden LJ considered that, in this situation, the court should proceed to value the potential claims (the quantum hearing) in order to determine whether those claims would exceed the amount of the company's deficiency as regards creditors so entitling the petitioner to relief on his petition. In the circumstances of an insolvent company, therefore, the court has to progress to valuation (the quantum hearing) before determining an entitlement to relief (the liability hearing) whereas in a solvent company the steps are sequential, a finding of an entitlement to relief followed by valuation (liability hearing followed by a quantum hearing).

The lower court had been wrong to dismiss the petition which should have been adjourned for a further hearing to determine whether the company would have had a surplus but for the breaches of duty in relation to remuneration, use of the trading name and sale of the goodwill. If that is found to be the case, then the petitioner had suffered unfair prejudice in respect of which the court could grant relief: *Maidment v Attwood* [2012] EWCA Civ 998, [2012] All ER (D) 203 (Jul).

Appropriate remedy need not be a purchase order

In an interesting unfairly prejudicial case (CA 2006, s 994), Briggs J concluded that, while it has become almost the norm to order the purchase of a petitioner's shares, that is not the only option open to the court which may decide on a bespoke solution not involving a buyout, at least in cases where leaving the warring parties as shareholders would not perpetuate an impossible joint-management relationship.

The case concerned a 1993 agreement between the shareholders of Company A (J and S, two brothers, holding 48% and 50%, respectively) following disagreements between them. In essence, the solution agreed on was that the hotel which the company managed would be leased to Company B (wholly-owned and run by S) on the basis that Company B would pay to Company A rent sufficient to fund a specified guaranteed dividend to J and the other shareholders. S would be the sole director of Company A.

The agreement was adhered to until 2010 when Company A ceased to pay the dividend. S said that the company had insufficient distributable profits to continue the arrangement which had never been intended to be perpetual and which could not be sustained in current market conditions.

Acknowledging that a claim based purely on breach of an agreement between shareholders unrelated to the conduct of the company's affairs cannot form the basis of an unfairly prejudicial petition, Briggs J accepted that the 1993 bargain was an agreement between the main shareholders in Company A and its then directors as to how its affairs were thereafter to be conducted with the dividend to be payable as long as the hotel was let to Company B. The case did fall therefore within CA 2006, s 994.

The court accepted the allegations of the petitioner that the rent charged to Company B had been less than the agreed rent and that this conduct was unfairly prejudicial to the petitioner's interests and to the advantage of S. It was clearly unfairly prejudicial to J's interests for Company A at S's direction to undercharge Company B while paying the agreed dividend (until 2010) out of accumulated but ever decreasing shareholders' funds, to a point where they had almost been exhausted by 2010.

In the circumstances, Briggs J held that the appropriate remedy was not to order that the petitioner be bought out but to hold the parties to the 1993 agreement. The purpose of the 1993 bargain was to confer sole control of Company A upon S while providing financial security to J. It was itself an agreed solution to a shareholder relationship in a quasi-partnership which had become impossible. The parties could have resolved upon a buy-out of J's interest in 1993 but they did not.

The court therefore ordered that S, as the sole director of Company A and on the basis of his breach of fiduciary duty, was to restore the diminution in shareholder funds attributable to his undercharging of rent; Company A was to demand rent at the full rate necessary to fund the dividend for as long as Company B remained in occupation of the hotel; and Company A was to resume paying the dividend as agreed out of its annual profits: *Sikorski v Sikorski* [2012] EWHC 1613 (Ch), 19 June 2012.

No reflective loss rule

Claim by secured creditor not subject to the rule

A secured creditor appointed an administrative receiver (AR) to a company and then became dissatisfied with the conduct of the AR and started proceedings for breach of duty only for the claim to be struck out on the basis that the claim offended the reflective loss rule.

That rule precludes a shareholder suing a third party in circumstances where the loss to the shareholder is only reflective of a loss suffered by the company and the shareholder's loss would be recovered in full if the company enforces its rights: *Johnson v Gore Wood & Co* [2001] 1 BCLC 313.

On appeal, the issue for the court was whether the no reflective loss rule debars a secured creditor of a company who has suffered loss (as the result of breaches of duties owed both to the secured creditor and the company by a defendant) from recovering that loss because the company is also entitled to recover that loss.

The appeal was allowed. There was nothing in the case law requiring the extension of the no reflective loss principle to circumstances such as those of the instant case. All the authorities are clear that the primary duty of the administrative receiver is to the debenture holder and not to the company.

The policy considerations which lie behind the no reflective loss rule (respect for corporate autonomy and to ensure the company's creditors are not prejudiced by the actions of individual shareholders and that there is no double recovery for the same loss) are not relevant in this context. On the contrary, policy considerations would seem to indicate that the rule against reflective loss should not apply to claims by a secured creditor. If the rule did apply then the person who has the benefit of the primary duty, and who has the primary entitlement to the loss, is being disabled from pursuing his claims directly and under his own control. It was difficult, the court said, to see what policy consideration would require this outcome.

In *Gardner v Parker* [2004] 2 BCLC 554 the Court of Appeal did extend the no reflective loss principle to a claim by a shareholder in his capacity as a creditor of a company, noting obiter that the rule would equally apply to a claim by a creditor who was not a shareholder of the company. But the court noted that a distinction must be drawn between secured and unsecured creditors. The unsecured creditor's prejudice arises only through the depletion of the company's assets whereas the secured creditor has the primary entitlement to obtain and retain damages for breach of the duty owed to the secured creditor by the receiver.

The creditor's claim should not have been struck out and the appeal was allowed: *International Leisure Ltd v First National Trustee Company UK Ltd* [2012] EWHC 1971 (Ch), [2012] All ER (D) 209 (Jul).

Cross-border Merger Regulations

Drafting error corrected by court

In an unusual judgment, the court has had to correct a drafting error in the Companies (Cross-Border Mergers) Regulations 2007, SI 2007/2974, reg 3(1). The outcome is of practical significance and a number of cases raising the same point had been adjourned to await this ruling.

These Regulations implement Directive 2005/56/EC on Cross-Border Mergers and make provision for three types of cross-border mergers, essentially two types of *mergers by absorption* whereby one or more transferor companies transfer all of their assets and liabilities to an 'existing transferee company' and one type of *merger by formation of a new company* where the transferee company is a new company formed for the purposes of or in connection with that merger.

In this case, the proposed merger was a merger by absorption and was between a company registered in Portugal and a company registered in the UK. The UK (transferee) company had been purchased as a shelf company for the purpose of this transaction. An issue arose as to whether it could be an 'existing transferee company' within the Regulations as reg 3(1) defined an 'existing transferee company' as 'a transferee company other than one formed for the purposes of or in connection with a cross-border merger'.

Henderson J concluded that, on a literal reading of that definition, it appeared to disqualify this UK company from acting as the transferee, though he could identify no discernible policy reason for such a restriction which was inconsistent with both the wording and the general facilitative aim of the Directive which the Regulations were intended to implement.

On the face of it, the Directive requirement that the transferee company in a merger by absorption should be an 'existing' company required nothing more than that the transferee company should already have been in existence at the time of the proposed merger.

Henderson J said that he was therefore driven to the conclusion that something must have gone wrong in the drafting of the Regulations when, on a literal reading of the definition of an 'existing transferee company', an entirely pointless and unexplained restriction had apparently been introduced. In his view, everything pointed to the conclusion that the definition was intended to do no more than exclude from either type of merger by absorption a transferee company which was formed for the purposes of or in connection with a merger by formation of a new company.

He concluded that it was open to the court to correct an error of this nature as part of the interpretive function of the court and he would read the definition in reg 3(1) as including at the end the words 'by formation of a new company.' An 'existing transferee company' is then defined for the purposes of a merger by absorption as 'a transferee company other than one formed for the purposes of or in connection with a cross-border merger by formation of a new company.'

He therefore declared that the UK company in this case was an 'existing transferee company' within the meaning of the Regulations and the court therefore did have jurisdiction under the Regulations to entertain an application by the company for the court to summon a meeting of its members: *Re Itau BBA International Ltd* [2012] EWHC 1783 (Ch), [2012] All ER (D) 206 (Jun).

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