C/M/S/ Cameron McKenna

Clearly corporate

Bulletin

July 2006

Contents

A recent survey revealed that 38% of those questioned said that they had been discriminated against in the workplace on the grounds of age, making it by extension the most common form of workplace discrimination. This could translate into a flurry of claims after new regulations come into force on 1 October 2006

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Age discrimination – are you ready?

The Employment Equality (Age) Regulations 2006 will make it unlawful to discriminate on the grounds of age. The Regulations are wide-ranging and will affect every aspect of the employment relationship. They will apply to all employers and cover employees, people who apply for work, trainees and other categories of worker.

Although the Regulations largely follow established discrimination law principles (for example, compensation is potentially unlimited and the onus of proof lies on the employer to rebut claims) there are fundamental differences. This is the first discrimination legislation which potentially affects every person working in the business. It is not restricted to a minority group but affects both old and young employees and will affect employees throughout their working life. Although the Regulations cover well-understood concepts such as direct and indirect discrimination, this is the first time that direct discrimination will be capable of being objectively justified. There are also a number of express exceptions to the Regulations, allowing age discrimination in certain circumstances.

Objective justification

The test of objective justification will be critical in determining the impact of the Regulations on employers. Objective justification consists of two elements: pursuing a legitimate aim and proportionality. Provided a particular discriminatory treatment, provision, criterion or practice can be objectively justified, an employer can continue it.

For an aim to be legitimate it must correspond with a real need on the part of the employer. Employers will need to provide evidence of the legitimate aim and not merely make assertions about it. According to guidance published by ACAS, a legitimate aim might include the health, welfare and safety of the individual (including protection of young or older people) and the particular training requirements of the job.

> *"The Regulations are wide-ranging and will affect every aspect of the employment relationship."*

A key question is whether cost can ever objectively justify discriminatory treatment.

If the discriminatory treatment, provision, criterion or practice pursues a legitimate aim, it still has to be proportionate. Although in general terms "proportionate" means that the method of pursuing the aim must be "appropriate and necessary", this is not an absolute test. It involves balancing the discriminatory effects of a measure with the importance of the aim pursued. For example, if the stated aim is to encourage loyalty the employer must be satisfied that using an age-related provision will actually achieve this, and that the aim cannot be achieved in a less discriminatory way.

A key question is whether cost can ever objectively justify discriminatory treatment. The ACAS guidance states that economic factors such as business needs and efficiency might be legitimate aims, but it clearly warns that it is not legitimate to discriminate just because it is cheaper than not discriminating. Until there is established case law on this, a practical interpretation is that, although cost may amount to a legitimate aim, it can only be taken into account along with other legitimate aims in determining whether or not a particular treatment is proportionate.

Benefits

One of the key exceptions for employers is that benefits linked to an employee's length of service of five years or less will continue to be lawful. The DTI guidance accompanying the Regulations states that this exception was included in order to enable employers to retain and reward experienced staff.

Where the difference in entitlement to benefits is based on service in excess of five years there is no blanket exception. Instead, there is a relatively low hurdle: employers must prove they reasonably believed that using length of service would meet a business requirement of theirs.

Unfair dismissal

The Regulations make specific changes to the law on unfair dismissal. In particular, they remove the upper age limit for eligibility to bring a claim of unfair dismissal so that, in future, all employees, irrespective of their age, will potentially be able to make a claim. As part of this change the Regulations remove the tapering of the basic award for claimants over 64 and remove the lower age limit for the purposes of calculating continuous employment.

Retirement

To counteract a flood of new claims, the Regulations also introduce a new potentially fair reason for dismissal: retirement. As a matter of employment law, retirement will no longer have its ordinary meaning, but will become a legally defined concept. The retirement provisions of the Regulations are likely to have the biggest impact on employers.

At present employers can force employees to retire at any retirement age which has been specified in their contract. There is no general protection from age discrimination and, as long as the specified age is the normal retirement date of the employer, there is no unfair dismissal case to answer. That is going to change from 1 October.

The underlying European Directive, which is being implemented by the Regulations, permits age discrimination if it is objectively and reasonably justified by a legitimate aim. After much consultation, the Government has decided that a national default retirement age of 65 is justified. It has therefore included a specific exception from the general rules of unlawful age discrimination for retirement at or above that age. This means that dismissal by reason of (compulsory) retirement when the person is at or over the age of 65 will be lawful, provided certain conditions are satisfied. Employers who have retirement ages below 65 will now need to examine them very carefully. Although it may be theoretically possible to justify a lower retirement age, this is bound to be difficult and will only apply in limited circumstances. (This new age does not affect normal pension ages under occupational pension schemes).

Employers are not, however, free of problems just because their normal retirement age is already at or above 65. Retirement will now be classed as another

potentially fair reason for dismissal. But employers will not have to prove retirement in the same way as they have to prove redundancy, for example. All employers must do is prove that the termination date is the planned retirement date and that they have followed the new retirement process laid down in the Regulations.

Schedule 6 introduces a "Duty to consider working beyond retirement". This means that employers will have a duty to notify their employees of impending retirement no more than 12 months (and no less than six months) before the intended date of retirement. Employers will also have a duty to notify these employees that they have the right to apply to continue working beyond the retirement age. If employers do not notify their employees in accordance with the new rules at least six months before the intended date of retirement they may have to pay a penalty of up to eight weeks' capped pay. If they fail to make the notification at all, or only give it within two weeks of the date of intended retirement, the eventual "retirement" will constitute an automatic unfair dismissal.

Employees who want to continue working beyond retirement must make their request in writing at least three months (but not more than six months) before the intended retirement date. The process is similar to the process for requesting flexible working. The employer must hold a meeting to discuss the request with the employee within a reasonable time and must give the employee notice of his decision as soon as is reasonably practicable after the date of the meeting. There is a right to be accompanied and an employee can appeal the decision.

Transitional provisions apply to retirements between 1 October 2006 and 31 March 2007.

The big change for employers is that they will now have to manage the retirement process actively and carefully. Forward planning and clear communication will be vital to ensure that retirements do not result in unfair dismissal or age discrimination claims. Employers will now routinely have to inform employees of their rights. But where there is a normal retirement age of 65 or above, employers will not be obliged to justify their decision to hold an employee to retiring at the agreed age.

Redundancy

Although the current formula for calculating statutory redundancy pay contains age-related criteria, the age-related elements of this formula have not been changed under the Regulations. The Government has stated that this will be objectively justifiable as well as lawful under the specific exception (at Regulation 27), which states that age discrimination will be lawful if it is done in compliance with a statutory authority.

However, there are some minor changes, which include the removal of the upper age limit of 65 for eligibility for statutory redundancy payments, the removal of tapering where the redundant employee is 64 and the removal of the lower age limit for calculating continuous employment for the purposes of any statutory redundancy payment.

It has, however, become reasonably common practice for employers to make payments to employees on redundancy that are greater than the employee's entitlement under the statutory scheme. Where there is a set policy or even a form of agreement (usually with a trade union), normally employers either modify the statutory formula or adopt their own formula based on a multiple of weeks' pay per year of service completed by the employee at the date of termination.

Regulation 33 deals specifically with enhanced redundancy payments and sets out three variations that can be made to the statutory formula to allow for enhancement. An enhanced redundancy payment calculated on this basis will be lawful under the Regulations. The variations that can be made are:

- removal or raising of the cap on weekly pay;
- applying a multiplier of more than one to the "appropriate amount"; and/or
- applying a multiplier of more than one to the overall figure, whether or not either of the above has been applied.

"Forward planning and clear communication will be vital to ensure that retirements do not result in unfair dismissal or age discrimination claims."

Employers should review their scheme rules and awards criteria and check that these will either comply with the Regulations or that any non-compliance can be objectively justified.

A redundancy enhancement formula not calculated on this basis will need to be objectively justified under the Regulations. The exception from the Regulations in relation to the provision of certain benefits based on length of service specifically excludes benefits awarded on termination of employment. Therefore, enhanced redundancy payments based purely on an employee's length of service will not be covered by the exception and must be objectively justified.

Employee share schemes

Many employee share schemes currently permit age-related discrimination, such as automatically preventing employees who are close to retirement from receiving new awards or favouring retiring employees over other leavers by allowing them to receive the full number of shares under their award. This will normally be discriminatory once the Regulations are in force.

Employers should review their scheme rules and awards criteria and check that these will either comply with the Regulations or that any non-compliance can be objectively justified. The summary position for age discrimination in the context of employee share schemes is that age discrimination will be unlawful unless:

- the discrimination is required to comply with specific legislation (in this case, particularly tax legislation for all-employee Sharesave and Share Incentive Plans which contain express retirement provisions);
- the discrimination is service-related (as in the case of qualification periods for participating in Sharesave and Share Incentive Plans) on the basis that it does not take into account a period of more than five years; or
- the discrimination is objectively justifiable.

While recognising loyalty and experience and motivating employees are likely to be objective grounds, employers have the burden of proof in justifying what could be discrimination. Express rules disadvantaging or favouring employees close to expected retirement age are unlikely to be objectively justifiable.

Some small changes to executive scheme rules will be required before 1 October 2006 to ensure that their provisions in this area are normally objectively justifiable going forward. Changes may also be needed to all-employee schemes. Scheme rules can normally be amended by Board resolution, and neither shareholder nor employee approval will usually need to be obtained.

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The UK takeovers regime has been overhauled and there is a new Takeover Code. Although the fundamentals of Code-regulated bids are unchanged, in certain practical ways UK takeover practice will now be different. This article highlights some of the more important new rules

Michael Jones

Peter Bateman

The new takeovers regime

The recent changes to the Takeovers regime have resulted from the implementation of the EU Takeovers Directive and the introduction of various unrelated amendments stemming from various Panel consultations. As well as changes to the Code, those aspects of the Directive that need a statutory basis have been introduced by means of the Takeovers Directive (Interim Implementation) Regulations 2006, which will be replaced when the Company Law Reform Bill comes into force.

Takeovers Directive

The Directive is intended to harmonise more closely the rules on conventional takeovers of EU-incorporated companies whose shares are traded on an EU regulated market (which, in the UK, means listed, but not AIM or OFEX, companies). Broadly, the Directive's rules are based on the UK model, so radical changes to the UK regime were not required. It is a "minimum standards" Directive: in other words, it requires member states to put in place certain basic rules in relation to takeovers but leaves them free to impose additional and more detailed rules. Most of the existing Rules that went beyond the Directive have been left intact, but in certain areas the UK regime has been modified to bring it into line with the Directive.

Jurisdiction

When a takeover is proposed, advisers will need to ascertain early on which regulator(s) will have jurisdiction over the bid. Often, the bid will be governed exclusively by one set of national rules – in the UK, this would mean principally the Takeover Code and the legislation governing the squeeze-out procedure – but in some circumstances jurisdiction may be shared between national regulators.

Implementation of the Directive has altered the scope of the Panel's jurisdiction so that, for example, the Code now additionally applies to all offers for companies and European Companies (SEs) that have their registered office in the UK, the Channel Islands or the Isle

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It is a criminal offence for the offer document or defence circular not to comply with the contents requirements set out in the Code.

of Man if any of their securities are admitted to trading on a regulated market in the UK or on a stock exchange in the Channel Islands or the Isle of Man.

Directive-regulated bids

All bids that are regulated by the Panel are subject to the same Code Rules. However, a Directive-regulated bid (where the bid is for an EU incorporated company whose shares are traded on an EU regulated market) differs from other bids in three main respects:

- Code Rules that implement or reflect the Directive (whether they were introduced or amended on implementation, or already existed) have been put onto a statutory footing and the Panel has been given additional powers to enforce them. In particular, the Panel can now apply to court to enforce any of these Rules, and can compel any person to provide it with copies of any document or other information that relates to a Directive-regulated bid.
- It is a criminal offence for the offer document or defence circular not to comply with the contents requirements set out in the Code. Although offer documents and defence circulars are likely to be prepared and verified in the same way as before, some investment banks are being urged by their advisers to drop the practice of making offers on behalf of their bidder clients.
- Instead of Part 13A of the Companies Act (and pending the coming into force of the Company Law Reform Bill, which contains equivalent provisions), the squeeze-out procedure in Schedule 2 to the 2006 Regulations applies.

The Schedule 2 rules are closely based on Part 13A, but, where the target has overseas shareholders with no registered address in the UK, and the bidder is concerned that sending the offer document overseas might breach local securities laws, it can extend the offer to them by placing a notice in the London Gazette and ensuring that the offer document is available for inspection at a place in an EEA state or on a website. Also, instead of having to serve notice to start the squeeze-out within two months of reaching the 90% threshold, the notice must be served within three months of the last day on which the offer can be accepted. Since the Code allows a bidder to leave its offer open for many months, or even indefinitely, this rule appears to impose no real deadline for the squeeze-out procedure to be initiated. Usually, though, the bidder will be keen to acquire 100% of the target as soon as possible.

Disclosure in annual directors' report

For financial years beginning on or after 20 May 2006, where a UK company has securities carrying voting rights admitted to trading on an EU regulated market at the end of that year, its directors' report will have to include certain information about its share structure, the rights attaching to its shares, and any rules or arrangements that could affect the success of a takeover bid.

For example, details will have to be given of:

- the rights and obligations attaching to each class of shares, including any restrictions on voting rights;
- any restrictions on the transfer of securities;
- each person with a significant direct or indirect holding of securities in the company, including any person who holds securities carrying special voting rights in the company; and
- any significant agreements to which the company is a party that take effect, alter or terminate upon a change of control of the company following a takeover bid. Although this sounds onerous, disclosure is only required of agreements to which the listed parent itself is a party – it does not catch agreements entered into by subsidiaries. In practice, few such agreements are likely to exist. Even where they do, it may be possible to avoid disclosure on the grounds that disclosure would be "seriously prejudicial" to the company (although this is probably a difficult test to satisfy).

Changes reflecting the Directive but applicable to all companies and bids

Special deals

Where an offer involves a special deal with favourable conditions for some shareholders (such as target management in an MBO who will be shareholders in the bid vehicle), target shareholders must now always be given the opportunity to vote on the arrangements at an extraordinary general meeting. Previously, an EGM was normally only required if the bidder and target management between them held more than 5% of the target's equity shares. The meeting will need to be factored into the timetable.

Where the bidder proposes any other arrangements to incentivise the target's management, the target's Rule 3 adviser must confirm publicly that, in its opinion, such arrangements are fair and reasonable.

Effect of the offer on target employees

Both the bidder and target must make the offer document available to their respective employees as soon as it is posted. The Panel has indicated that it will consider a document to have been made available if employees or their representatives are informed – through the channels normally used by the company for staff communications – of the existence of the relevant announcement or document and of where and how they can access it. For many companies, this will probably mean notifying employees by means of a general email that contains a hyperlink to the page on the company's intranet where the offer document is posted.

In the offer document, the bidder must set out "its strategic intentions for the offeree company, and their likely repercussions on employment and the locations of the offeree company's places of business" and its proposals to make "any material change in the conditions of employment" of target employees. This requirement goes further than the previous Code Rules, and bidders are therefore likely to give more detailed consideration to staff issues before the offer document is posted.

Employee views on the offer

Target employees or their representatives are entitled to submit a written opinion on the implications of an offer and, provided the opinion is received in good time before publication of the offer document or defence circular (as appropriate), the opinion must be appended to it.

In some circumstances, the target may have to consult its employees pursuant to the Information and Consultation of Employees Regulations 2004; but if not, in a recommended offer where the offer document is posted simultaneously with, or very shortly after, the announcement of a firm intention to make an offer, target employees will have no opportunity to submit their opinion in time. Where there is a gap between the announcement and posting of the offer document, or where the offer is hostile, it is probably reasonable for the target to impose a deadline requiring the employees' opinion to be delivered shortly before the document is due to be bulk-printed. The Code does not restrict the length or content of the opinion: if the target or bidder disagrees with statements made by the employees, it may want to include a riposte in the offer document or defence circular.

Non-Directive changes that affect all companies and bids

SARs

The Panel has abolished the Substantial Acquisitions Rules, so that it is now possible to carry out a market raid before the announcement of an offer or possible offer and acquire up to 29.9% of a company in one go. As a result, it is more difficult for a target and other potential rival bidders to react before a raider has acquired a stake large enough effectively to block any competing offer. The tactic of using a market raid to knock out a rival bidder has already been dramatically illustrated in the recent battle for BAA: on the morning when the Goldman Sachs consortium were expected to tell BAA that they would make an offer trumping an existing bid by Ferrovial, Ferrovial's bankers,

> *"Target employees or their representatives are entitled to submit a written opinion on the implications of an offer…"*

"…it is now possible to carry out a market raid before the announcement of an offer or possible offer and acquire up to 29.9% of a company in one go."

Citigroup, managed to buy up nearly 13% of BAA's shares in the market, taking their stake to just below 29%, and effectively ending the Goldman Sachs move.

The rules relating to tender offers have been retained as a new Appendix 5 to the Code.

Dealings in long derivatives and options

A large number of technical changes have been made to the Code so that, broadly speaking, all dealings in long derivatives and options are now treated as dealings in the underlying shares. This is particularly relevant for the purposes of Rules 5 (timing restrictions on acquisitions), 6 (purchases resulting in an obligation to offer a minimum level of consideration), 9 (mandatory offers) and 11 (nature of consideration to be offered). Essentially, a person has a long position under a derivative or option if he will benefit if the price of the underlying security rises.

The new approach is intended to recognise the commercial reality that the counterparty to a derivative transaction will almost invariably acquire actual shares to hedge its exposure under the contract. Although there may be no formal or legally binding agreement to do so, the counterparty will usually deal with the hedging shares in a manner that is consistent with the commercial objectives of its client – giving the client at least a measure of de facto control over those shares.

As any control a person has over shares held by the counterparty to a long position will not be diminished by that person entering into a short position with a different counterparty (even if doing so flattens the person's economic exposure), for the purposes of the control provisions the Panel will not normally permit short positions to be offset against long positions.

As an exception to this general approach, derivatives and options will not count towards a bidder's acceptance condition under Rule 10.

Further details of these changes, and those relating to the implementation of the Takeovers Directive, can be found on LawNow, our free on-line information service.

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With this year's AGM season now well under way, we are likely to see leading companies raising the bar in their directors' reports, dealings with shareholders, and meeting procedures. Best practice in corporate governance never stays still

Sean Watson

Peter Bateman

Complying or explaining: corporate governance and shareholder engagement

2005 was the first year that listed companies had to report fully on the extent of their compliance with the revised Combined Code. Following its review of how the Code was being implemented, the Financial Reporting Council (FRC) announced earlier this year that it did not intend to make any significant further changes. Despite the protest that greeted some of Sir Derek Higgs' proposals, the FRC found that the revised Code had bedded down well and was generally considered to be having a positive impact. The latest amendments were announced in June 2006 and include:

> *"…the FRC found that the revised Code had bedded down well."*

- The Chairman will be permitted to sit on (but not chair) the remuneration committee provided he was considered to be independent on appointment. The FRC estimates that nearly 30% of FTSE 350 companies, and a higher percentage outside the FTSE 350, currently choose to explain their non-compliance with, rather than comply with, the provision in the Code that requires all committee members to be independent non-executives (the chairman is not considered independent).
- To allow shareholders to communicate reservations about a proposal at any general meeting without voting against it, companies should include a Vote Withheld box on proxy voting forms, as recommended in Paul Myners' report to the Shareholder Voting Working Group. The proxy form and any announcement of the results of a vote should explain that withheld votes are not votes in law and are not counted for or against the resolution. According to Research Recommendation and Electronic Voting (RREV), for 92% of company meetings of the FTSE 100 in 2005 where votes were disclosed either publicly or to RREV, voting forms had an abstention or vote withheld option. The CREST electronic proxy form already includes a Vote Withheld box.

"Two particular areas in which companies continue to clash with investors are executive remuneration and the independence of NEDs."

- Where a vote at any general meeting is taken on a show of hands but does not go to a poll, the company should disclose (both at the meeting and on a website) the number of shares in respect of which there are valid proxy appointments, and the votes for and against, and votes withheld, shown on the proxies. For votes taken on a poll, the Company Law Reform Bill is expected to require companies to disclose the results on their websites.

Current levels of compliance with the provisions of the Code by FTSE 100 companies are variously estimated at somewhere between a third and a half. It is clear that rigid compliance with every provision is not required: indeed, companies are expected to explain how and why they do not comply, so that investors can cast their votes in the light of all the relevant circumstances. The FRC reported that respondents to its consultation believe that, since the introduction of the revised Code, the quality of corporate governance in listed companies has improved, and that there has been an increase in constructive dialogue between companies and investors.

Until the Listing Rules are changed to refer to the updated Code, compliance with it will be voluntary, but the FRC is encouraging companies to adopt it for reporting years beginning on or after 1 November 2006. The updated Code is available on the FRC's website: www.frc.org.uk.

Smaller listed companies and AIM companies

Although not included in the FRC's proposed changes to the Code, there is some pressure from certain companies and investors for the FRC to create a specially tailored version of the Code for companies outside the FTSE 350. The Code already makes a few express concessions to smaller companies – for example, independent NEDs should number at least two, but need not make up at least half of the board – and when assessing corporate governance disclosures shareholders are encouraged to take account of "the size and complexity of the company and the risks and challenges it faces". But an FRC survey last November showed that 45% of smaller companies do not believe the Code works well in practice. Most smaller companies have fewer resources to set up and maintain Code-recommended practices, and to provide full explanations for any non-compliance.

In August 2004 the Quoted Companies Alliance (QCA), which represents the interests of smaller listed companies, published guidance for its members on those provisions of the Code which may create difficulties for smaller companies and which may require explanation rather than compliance. But the QCA guidance does not amount to an alternative Code.

AIM companies are not strictly required to observe the Code, but last July the QCA published a set of corporate governance guidelines for AIM companies, designed to provide a simple minimum standard of best practice. Among other things, it recommends that the roles of chairman and CEO should be split; that a company should have at least two independent NEDs, one of whom may be the chairman; and that audit, remuneration and nomination committees should be established, each comprising at least two independent NEDs. As yet, this "alternative" Code has not met with broad market approval.

Areas of controversy

Two particular areas in which companies continue to clash with investors are executive remuneration and the independence of NEDs. In December, the ABI reissued its annual guidelines on executive remuneration and share incentive schemes. The revised guidelines emphasise that:

- Remuneration committees are responsible for ensuring that all reward arrangements remain appropriate and challenging. Where necessary, employee share schemes should be reviewed to check that grant levels, performance criteria and vesting

conditions previously approved by shareholders remain appropriate.

- The vesting of awards under share incentive schemes should be conditional on satisfaction of performance criteria that are stretching in comparison to an appropriate defined peer group of sufficient size or another relevant benchmark. For example, where the lowest level of performance to achieve an award is reached, the initial level of award should be modest and there should be no large initial award or "cliff" vesting. Higher levels of award should vest as performance increases, with full vesting only arising on achievement of significantly greater levels of performance.
- Shareholders should be given enough information in the remuneration report to judge the appropriate size of the award for any given performance level. The maximum level of grant should also be disclosed.
- Where an employee terminates his employment or is dismissed for cause, any unvested options or conditional share-based award should normally lapse. Where an employee is otherwise unable to complete the vesting period, vesting should occur on a pro-rata basis only, and performance conditions should still apply.
- Where, in the event of death or cessation of employment of an option holder or where a company is taken over (except where arrangements are made to roll over options into options over shares in the bidder), outstanding options vest or have already vested, they must be exercised (or lapse) within 12 months.

While executive remuneration is likely to remain controversial, the fact remains that to date only six advisory votes on remuneration reports have been lost.

Independent NEDs are regarded by many investors as a bastion of good corporate governance. Assessing whether or not a particular director is in practice able to exercise his judgement independently of any personal interests or outside pressures is, of course, not something that can be done purely by reference to objective criteria, such as material business relationships with the company or remaining on the board for more than nine years. Institutional investors have made it clear that, where companies – as they often do – consider a NED to be independent notwithstanding the existence of such indicators, it is not enough simply to assert the individual's independence of character. Shareholders will look closely at the justification given and, in borderline cases, at other circumstantial evidence indicating independence – such as whether the company's remuneration policies comply with best practice.

In its report on "Board effectiveness and shareholder engagement", RREV devoted six pages to the factors that NAPF members take into account when assessing independence. They also give various examples of circumstances where investors have accepted company explanations of why a particular NED should be considered independent. A company concerned about this issue would do well to read this section of the report (which is available on RREV's website: www.rrev.co.uk).

Shareholder engagement

It is fundamental to the success of the comply or explain model that shareholders engage actively and intelligently with their investee companies – and that they have weapons at their disposal to make their views properly felt. In November Paul Myners reported that voting levels in FTSE 100 companies have increased from around 50% in 2003 to 61% in 2005. Roughly the same level of engagement applies across the rest of the FTSE 350. Electronic voting is increasingly being used: in the six months to 30 June 2005, 42% of the FTSE 100's share capital was voted electronically, compared to 22% in the previous year, and every company in the FTSE 100 now allows electronic voting.

Both Myners and the Government are looking at ways to increase shareholder engagement further by removing barriers to voting where investors hold interests in shares through ISAs, nominee accounts and intermediaries. Technical difficulties have forced withdrawal of clauses in the

> *"Electronic voting is increasingly being used… and every company in the FTSE now allows electronic voting."*

"…in many US listed companies it is difficult for shareholders to remove directors or to put resolutions…"

Company Law Reform Bill designed to enable registered shareholders in listed companies to nominate someone else (such as a beneficial owner) to exercise voting rights and receive documents in their place, but the Government has promised to explore other ways of achieving this.

Disclosure of institutional voting records

It seems likely that the Company Law Reform Bill will include a power for the Secretary of State to make regulations compelling institutional investors to disclose their voting records. The Government has threatened to use this power if enough institutions fail to disclose on a voluntary basis. It will be for the Secretary of State to decide whether disclosure should be just to beneficiaries, to a wider class of interested parties, or to the public at large. More than a dozen institutions, including Fidelity International, F & C Asset Management, Hermes and CIS, have agreed over the last few months to publish their votes on each resolution proposed by their UK and overseas investee companies.

What effect will this have on corporate governance? The main aim is to encourage institutions actually to vote their shares and in doing so, it is hoped, to assess whether management's proposals accord with the investors' own views about what is best for the company. In most cases, public disclosure is likely to reveal that the institution supported management's proposals: for example, in the 12 months to 30 June 2005 Fidelity voted against one or more resolutions at only 392 meetings, compared to 2,474 meetings at which it voted in favour of all the resolutions proposed by management. Where support was withheld, brief reasons were usually given. Some institutions are concerned that pressure groups may try to "name and shame" them for supporting proposals that the group disapproves of, but the risks may be more apparent than real. Hit rates on the pages of institutions' websites where voting records have been published were reported in the House of Lords debate on the Bill to be very low, and one manager who disclosed had had no questions raised as a result.

General meetings and shareholder rights

Essential to the effectiveness of the comply or explain model is that shareholders have the means to voice their disapproval of any explanations they do not like, to put pressure on management to amend or drop proposals, to put their own resolutions, remove existing directors and, ultimately, to sell out or take control of the company themselves. In the UK such opportunities and rights are usually readily available, at least in principle, but the same is not always true elsewhere in Europe or in the United States. For example, in some EU member states, to be eligible to vote at a general meeting, shareholders must deposit their shares with a credit institution or other entity a few days before the meeting and cannot then trade them until the end of the meeting. This "share blocking" is a huge obstacle to voting, as institutional shareholders often prefer not to vote rather than lose the opportunity to sell their shares during the blocking period. A survey commissioned last year by the ABI also found that about a third of companies in the FTSE Eurofirst 300 index (particularly French, Dutch and Swedish companies) have voting structures that "distort voting rights and make management less accountable to shareholders". Similarly, in many US listed companies it is difficult for shareholders to remove directors or to put resolutions, and boards often have power effectively to block takeovers by putting in place poison pills.

Additional rights under the Company Law Reform Bill

In the UK, the Bill is likely to add to the weapons available to shareholders. In particular:

- Shareholders in listed companies who hold at least 5% of the voting rights, or who number at least 100 (with an

average of at least £100 of share capital each) will have the right to publish on the company's website free of charge a statement of any concerns about the audit, or the circumstances in which the auditors have resigned, that they intend to raise at the AGM.
- Shareholders in public companies will be able to require the company to circulate resolutions and any accompanying statement at the company's expense if the materials are provided to the company before the end of the financial year.
- Listed companies will have to disclose the results of any poll on their website. Some listed companies already do this. Shareholders who hold at least 5% of the voting rights, or who number at least 100 (with an average of at least £100 of share capital each), will be able to require the directors to obtain an independent report on any polled vote.
- Members of both private and public companies will be able to appoint more than one proxy. Proxies will be given the same rights as registered holders to ask questions, demand a poll and vote on a show of hands at general meetings (as well as on a poll).

Consistency across Europe

At a European level, the Commission is concerned to ensure that member states all provide shareholders in listed companies with certain minimum rights. In January it proposed a Directive on Shareholder Rights, which, if adopted, would have to be implemented by 31 December 2007 (although the deadline may slip). Among other things, the Commission proposes that:

- At least 30 calendar days' notice should be given for all general meetings, and the meeting documents (including proxy forms) should be published on the issuer's website not less than 30 calendar days before the meeting.
- Shareholders from all countries must have the right to add items to the agenda for a general meeting and to table resolutions. Where the right is subject to a minimum stake condition, the minimum stake must not exceed the lower of 5% of the share capital of the issuer or a nominal value of €10 million.
- Share blocking should be replaced by a record date system. The actual record date will be left for determination by member states, but must not be earlier than 30 calendar days before the meeting.
- Shareholders must not be prevented from participating in general meetings by electronic means. However, the technology is not yet advanced enough for the Commission to make electronic voting compulsory.
- Shareholders must be permitted to ask questions orally at general meetings and/or in written or electronic form ahead of the meeting. Issuers must respond to those questions, and post the responses on their websites, subject to any legitimate concerns over confidentiality.
- Member states must not require proxies to meet any eligibility criteria (for example, that the proxy be a family member or another shareholder, or that the appointment be notarised), except where strictly necessary to identify the shareholder and the proxy holder. Proxies should be capable of being appointed electronically.
- Companies must not require intermediaries or nominees who hold shares for investors in omnibus accounts to separate out the holdings of each investor temporarily before any votes are cast.

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…the Commission is concerned to ensure that member states all provide shareholders in listed companies with certain minimum rights.

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Whatever the reason a company or group wishes to demerge, it must understand the tax reliefs that go with the alternative structures that are available – as well as the terminology

Demerging without tears

When a company or group demerges it divides an activity or business it has been carrying on into one or more companies (or groups of companies) that are in separate – *but not necessarily different* – ownership. There can be many reasons for doing this. Separating businesses or activities that are not compatible into separate vehicles, for example, could ensure that the value of each underlying activity or business is fully reflected in the share price. Alternatively, there may be a commercial need to divide a jointly-owned group or to break up a group or company in order to facilitate the sale of part of a business or activity.

Leaving aside court schemes, there are three basic structures for demergers, each with its attendant tax reliefs, and it may even be possible to combine the structures or adopt a hybrid form. It is possible to apply for advance clearance from HM Revenue & Customs that the tax reliefs apply. Consent is generally obtained within 30 days.

> *…there are three basic structures for demergers, each with its attendant tax reliefs…*

Direct demerger – structure

Also known as a **straight** or **direct statutory** demerger (as it relies on provisions in the Taxes Act), a direct demerger is the simplest of the structures. It involves the payment of a dividend in specie by a company (the **distributing company**) to its shareholders of the shares in a subsidiary (the **demerged company**). In order to be able to declare a dividend the distributing company must have sufficient distributable reserves, and its articles of association are likely to require shareholder approval of the dividend. The consent of creditors may also be needed.

Direct demerger – tax reliefs

For **shareholders** receiving the dividend:

- if the dividend fulfils the conditions set out in section 213 of the Taxes Act it will be classed as an exempt distribution and on its receipt individual shareholders will not suffer any income tax or be regarded as disposing of their shares in the distributing company for the purposes of capital gains tax. Instead, shares in the distributing company and shares in the demerged company are treated for tax purposes as a single holding acquired by shareholders when they acquired their shares in the distributing company.
- corporate shareholders receiving the dividend will not suffer any corporation tax on income and may (where conditions are met) opt for the same "no disposal"

treatment as individual shareholders. Alternatively, they may be able to apply the substantial shareholdings exemption to any gain. The substantial shareholdings exemption may apply to gains made on the sale of shares in a trading company by a company which is itself a trading company, or the holding company of a trading group, where the shares disposed of entitle the shareholder to 10% or more of the rights in the company whose shares are sold.
- it is usually possible for the dividend to be structured so as to avoid stamp duty arising on the transfer of the shares in the demerged company.

For the **distributing company**:

- provided the dividend is an exempt distribution it will not trigger shadow advance corporation tax if the distributing company has surplus advance corporation tax.
- on the payment of the dividend the distributing company will make a disposal of the shares in the demerged company at market value for tax purposes and a gain subject to corporation tax may arise if the base cost of the company in the shares is lower, unless the substantial shareholdings exemption can apply.

For the **demerged company**, the dividend will result in its leaving the distributing company's group. Where this happens by reason only of an exempt distribution, relief is given for any degrouping charges that may have arisen in the demerged company.

Indirect demerger – structure

This is also known as a **three-cornered** or **indirect statutory** demerger. A dividend in specie is declared by the distributing company in favour of its shareholders, but the dividend is satisfied not by a direct distribution by the distributing company to the shareholders but instead by its transferring shares in the demerged company or the assets of the demerged trade to a newly formed company. The new company then issues shares to the shareholders of the distributing company. As with a direct demerger, the distributing company must have sufficient distributable reserves and shareholder approval and creditor consents may be required. Unlike a direct demerger, however, an indirect demerger can be used to demerge assets (albeit to the new company rather than directly to shareholders) as well as shares and, in addition to other tax reliefs, there is relief for any corporation tax on chargeable gains that arises in the distributing company.

Indirect demerger – tax reliefs

For **shareholders** receiving shares in the new company:

- as with the direct demerger, if the dividend fulfils the conditions set out in section 213 of the Taxes Act it will be classed as an exempt distribution and on its receipt individual shareholders will not suffer any income tax.
- corporate shareholders will not generally pay corporation tax on dividends received from other UK resident companies.
- if the demerger meets the statutory definition of a scheme of reconstruction in schedule 5AA of the Taxation of Chargeable Gains Act 1992 the shareholders will not be regarded as making a disposal of shares in the distributing company for the purposes of tax on chargeable gains. Instead, shares in the distributing company and shares in the demerged company are treated for tax purposes as a single holding acquired by shareholders when they acquired their shares in the distributing company.

For the **distributing company**:

- provided the dividend is an exempt distribution it will not trigger shadow advance corporation tax if the distributing company has surplus advance corporation tax.
- if the demerger meets the statutory definition of a scheme of reconstruction the distribution of shares or assets by the distributing company will not result in the distributing company realising a

"…an indirect demerger can be used to demerge assets (albeit to the new company rather than directly to shareholders) as well as shares."

"The insertion of the new parent company above the distributing company in the group structure can be achieved in a number of ways."

gain for tax purposes. Instead, the distributing company is treated for tax purposes as if the shares or assets in the demerged company or trade were transferred for a consideration that does not give rise to a gain or a loss, and the new company inherits the distributing company's base cost in those shares or assets. In the case of shares, the distributing company may, if conditions are met, be able to apply the substantial shareholdings exemption.

For the **demerged company** where shares have been distributed, the dividend will result in its leaving the distributing company's group. Where this happens by reason only of an exempt distribution, relief is given for any degrouping charges that may have arisen in the demerged company.

For the **new company**:

- the distribution of shares in the demerged company or assets of the demerged trade may trigger a liability for stamp duty, stamp duty land tax or stamp duty reserve tax. Relief from stamp taxes is available if certain conditions are met. Restrictions on the application of these reliefs to non-UK incorporated companies were removed in the 2006 Budget.
- in the case of a transfer of assets of a demerged trade, the treatment of any losses available for carry forward and capital allowances associated with the trade will need to be considered.

Liquidation scheme – structure

This is also known as a **section 110 scheme** (referring to provisions in the Insolvency Act), and involves the liquidation of the distributing company. In the course of the liquidation the assets (including shares in subsidiaries) of the distributing company are transferred to two or more newly formed liquidation companies. In consideration of the transfer of the distributing company's assets, the new companies issue shares to the shareholders of the distributing company in satisfaction of their rights on the winding up of the distributing company.

The involvement of a liquidator necessarily extends the time taken to effect the demerger and probably adds to the cost, but this method is useful where the distributing company has negative or insufficient distributable reserves, and is available where the distributing company cannot declare an exempt distribution in a statutory demerger because the relevant conditions are not met. It can also be used to divide the activities of a company or group prior to a third party sale.

It may not be feasible to liquidate an active company, and it is therefore common to insert a newly formed parent company into the group structure above the distributing company. The new parent company is then liquidated. This means additional steps to the structure and may require additional shareholder approvals and creditor consents. For example, it may be necessary to proceed by way of a takeover offer, so as to be able to squeeze out minorities under the Companies Act compulsory acquisition provisions (or under new regulations where the Takeover Directive applies). This will not work unless the offer is accepted in respect of at least 90% of the shares that are the subject of the offer.

Liquidation scheme – tax reliefs

The insertion of the new parent company above the distributing company in the group structure can be achieved in a number of ways. Typically, it involves the shareholders in the distributing company exchanging their shares in the distributing company for shares in the new parent company.

- For tax purposes, it is likely that the **shareholders** will avoid a charge to tax on gains arising as a result of the disposal of shares in the distributing company by obtaining rollover relief. The relief treats the exchange as involving no disposal of the shares in the distributing company and treats those shares and the shares in the new parent as the same asset for tax purposes and as if the shares in the new parent company were acquired when the shares in the distributing company were acquired.

- The next step is to ensure that the **new parent company** receives a transfer of all of the assets of the distributing company that are to be demerged. This transfer may be treated for tax purposes as taking place at a consideration that gives rise to neither a gain nor a loss for the distributing company, and the new parent company inherits the base cost of the distributing company in the assets. Group relief may be available to prevent stamp duty, stamp duty land tax or stamp duty reserve tax arising on the transfer.

On liquidation of the new parent company, the shareholders will receive a dividend in satisfaction of their rights on the winding up that will be satisfied by the issue of shares in the newly formed liquidation companies.

- Dividends received in respect of share capital on a winding up are expressly excluded from the scope of income tax and, if the liquidation falls within the definition of a scheme of reconstruction, the **shareholders** will not be regarded as making a disposal of their shares in the new parent company. Instead, the shareholders' shares in the new parent company and the shares that they receive in the liquidation companies will be treated for tax purposes as the same asset and as if the shares in the liquidation companies were acquired when the shares in the new parent company were acquired.
- The payment of a dividend by the new parent company in its winding up does not result in its being regarded as making a disposal of the assets distributed such that a gain subject to tax arises. Instead, the assets are regarded as having been transferred by the new parent company for a consideration that results in neither a gain nor a loss, and the liquidation companies inherit the new parent company's base cost in the assets.
- There is no specific relief from degrouping charges that may arise in any of the companies involved in a liquidation scheme. Care therefore needs to be taken to anticipate the triggering of any degrouping charges so that, by planning, the charges can be removed, limited or sheltered.
- The transfer of shares or land in a liquidation may attract stamp duty or stamp duty land tax. Specific reliefs are available if conditions are met. On a transfer of assets the availability of any losses going forward, and the treatment of capital allowances, must also be considered.

Court scheme

A combination of factors or circumstances may make these structures unattractive – for example, technical difficulties with reserves, non-accepting shareholders preventing the squeeze-out following a takeover offer in a liquidation scheme, or stamp duty costs.

A court-approved scheme of arrangement in accordance section 425 of the Companies Act may be the solution. Although it can be more complicated (with ramifications in terms of timing and cost), a court scheme will in general utilise some of the reliefs described above and takes advantage of the court's power to get round problems that may otherwise be insurmountable. Just the fact, for example, that the squeeze-out of minorities can be achieved with only 75% shareholder approval may make all the difference.

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"…a court scheme will in general utilise some of the reliefs described above and takes advantage of the court's power to get round problems that may otherwise be insurmountable."

Gary Green

Simon Howley

Treasury shares have become a familiar feature of the business at listed and AIM company annual general meetings. Their introduction necessitated a great many consequential changes, but the concept is straightforward: that companies should be able to hold bought-in shares until it is advantageous to place them back in the market

A recap on treasury shares

Qualifying shares

To qualify as treasury shares, shares in UK companies must be listed or traded on AIM, or listed or traded on any of the equivalent EEA markets. Shares of private companies, and shares of public companies that are not qualifying shares, are excluded.

"When a company buys in its own qualifying shares it can hold them in treasury instead of having to cancel them."

When a company buys in its own qualifying shares it can hold them in treasury instead of having to cancel them. If it cancels them, the issued (but not the authorised) share capital is diminished correspondingly, and an amount equal to the aggregate nominal value of the shares is transferred to capital redemption reserve. If it places them instead in treasury, it can hold the shares for later cash sale or in order that they may be transferred for the purposes of or pursuant to an employees' share scheme, or it can cancel them at any time. The purchase and sale of treasury shares is treated for tax purposes as a normal buyback and fresh issue (but see below as to stamp duty).

Not more than 10% of the aggregate nominal value of the issued share capital or of any class of share capital may be held in treasury. If the shares cease to be qualifying shares they must be cancelled immediately. This would arise, for example, if the shares were de-listed, although not if they were merely suspended. If the 10% limit is exceeded at any time, enough treasury shares to bring the company within the limit must be cancelled or disposed of within 12 months (bearing in mind that cancellation, as opposed to sale or transfer, will use up more shares, as cancellation diminishes the issued share capital by reference to which the limit is set). In either case, the company's officers will be liable to fines if the company is in default.

Taking shares into treasury

For a normal buyback, at present a company must have authority in its articles to buy its own shares. The purchase must be authorised by shareholders, the shares must be fully-paid and (for a public company) must be paid for out of distributable profits or the proceeds of a fresh issue. There may be further hurdles: a listed company, for example, must also comply with Chapter 12 of the UKLA Listing Rules and the recommendations of the ABI Investment Committee in relation to such matters as shareholder approval by special resolution, price parameters and the timing and maximum amount of the buyback.

Shares intended for treasury will be bought by the company in accordance with this regime but must be paid for out of distributable profits. In fact, whenever qualifying shares are bought-in using distributable profits they are treated as potential treasury shares. The directors must determine at that point (if they have not already done so when deciding to make the purchase) whether the shares are to be cancelled immediately or held in treasury (assuming they are not being immediately sold or transferred pursuant to an employees' share scheme) – in which case they should proceed with registering the shares (see below). The company's articles of association should be checked to ensure that they do not override this by stipulating the immediate cancellation of all bought-in shares.

The Listing Rules require the relevant circular to include (among other things) a statement as to whether the company intends to cancel any bought-in shares or hold them in treasury. Most companies taking shares into treasury simply say that the directors will in due course cancel or dispose of them in one of the permitted ways according to the circumstances at the time of their decision.

When shares are taken into treasury the company becomes registered as a member of itself in respect of the shares. They cannot be held by a nominee on the company's behalf, so shares in CREST have to be changed back to paper form if the company is not itself a CREST member or sponsored by a CREST member.

Details of the shares to be held in treasury (ignoring any shares bought in at the same time that the directors have decided to cancel immediately, which must be notified on Form 169) must be filed on Form 169(1B) at Companies House within 28 days of the delivery to the company of shares purchased under the authority. The form must set out the number and nominal value of the treasury shares and the date they were delivered, and is treated as the instrument of transfer; ad valorem stamp duty at 0.5% of the purchase price is payable on it.

While shares are held in treasury

While in treasury:

- the shares carry no right to attend or vote at meetings or to receive distributions (although if redeemable shares are redeemed while the company holds them it is entitled to the redemption proceeds).
- the company cannot grant a charge over the shares, since the Companies Act prescribes what may be done with treasury shares and does not include granting security over them.
- the shares confer no right to participate pre-emptively in new issues by the company: the other shareholders' rights are determined by reference to their due proportion of the aggregated share capital excluding the treasury shares.
- if its articles permit, the company can receive fully-paid bonus shares allotted in respect of treasury shares. The shares are treated as if they were treasury shares purchased at the time of allotment. The capitalisation provisions in regulation 110 of the Table A model articles in fact disallow this, as they provide that bonus shares must be allotted only to holders who are entitled to dividends. Companies are likely to have equivalent provisions in their articles and may wish to amend them.

"…the shares carry no right to attend or vote at meetings or to receive distributions."

"Treasury shares… have to be offered rateably to the other shareholders unless the sale is covered by a section 95 disapplication resolution."

The definition of "relevant share capital" in section 198 of the Companies Act excludes shares held in treasury, so if, for example, the company takes 3% of a class of voting shares into treasury it will not have to notify that interest to itself under the section. Other holders of the same class of share may, however, have to notify the company of their interests because by taking the shares into treasury the company will reduce the aggregate nominal value of relevant share capital and therefore increase the others' percentages. A percentage decrease (also potentially notifiable) will occur if treasury shares are sold (see below) or transferred to an employees' share scheme. This corresponds with the position on a normal buyback and fresh issue of shares.

Treasury shares have been carved out of the Companies Act when calculating qualifying thresholds (for example, the 10% threshold for members wishing to requisition an extraordinary general meeting, and the tests as to whether a director controls or is associated with a company for the definition of "connected person" in section 346). Some companies have amended their articles of association where they reiterated provisions in the Act as it was before treasury shares were introduced: for example, articles dealing with consent to the variation of class rights customarily refer to the three-quarters majorities stipulated by section 125 of the Act, which now provides for treasury shares to be excluded from the computation.

The Listing Rules require that, when listed companies seek shareholder authority under section 80 of the Companies Act to allot new shares, the circular containing the resolution must state the number of shares in treasury as at the date of the circular, and the proportion of the total ordinary share capital they represented (calculated exclusive of treasury shares) as at the latest practicable date before publication of the circular. The ABI pre-emption guidelines limit the number of shares over which section 80 authority may be taken to a number equal to the lesser of the authorised but unissued ordinary shares and one-third of the issued ordinary shares. There is no indication that companies must exclude treasury shares from the issued shares when calculating the third.

Selling treasury shares

Treasury shares sold by the company fall within the scope of section 89 of the Companies Act, like newly-issued shares, and therefore have to be offered rateably to the other shareholders unless the sale is covered by a section 95 disapplication resolution. No disapplication is needed, however, for shares transferred under an employees' share scheme.

- The company will want the disapplication resolution to comply with the ABI pre-emption guidelines, which restrict non-pre-emptive issues in any year to 5% by nominal value of the issued ordinary shares, and to 7.5% in aggregate in any three-year period. The Pre-emption Group Statement of Principles on Disapplying Pre-emption Rights (May 2006), to which the ABI and others subscribe, states that any sales of treasury shares counts towards the 5% limit in any year, but not towards the 7.5% limit. The Listing Rules require the company to state the percentage of the issued ordinary share capital (by implication, including treasury shares) that the disapplied amount represents as at the latest date before publication.
- The form of section 95 resolution should expressly refer to the sale of treasury shares as an alternative (wholly or partly) to the allotment of equity securities pursuant to a section 80 authority. There is no requirement that the disapplication should expire in relation to treasury shares at any particular time, but it is normally convenient to make it expire at the same time for sales of treasury shares as for new allotments.
- A sale of treasury shares to a related party taking up its entitlement in a pre-emptive offering is not subject to the related party transactions regime under the Listing Rules.

Sales of treasury shares (but not transfers under an employees' share scheme) must be made for cash. The definition broadly

matches the definition of "paid up or allotted for cash" in the Companies Act, and covers cheques, undertakings to pay cash and releases of the company's liability for a liquidated sum, but undertakings must be to pay cash within 90 days. If the proceeds exceed what the company paid for the shares, the excess is treated as (undistributable) share premium, but otherwise the proceeds are realised profit. As the company will have had to use distributable profit to buy the shares, this does no more than restore profit to that extent, but this is better than the position on a normal buyback and fresh issue. The amount paid by the company is calculated using the weighted average price method - in other words, the total cost divided by the total number of shares bought; any bonus treasury shares are treated as having been acquired for nothing.

Form 169A(2) must be filed when the shares are sold, cancelled or transferred. A fixed duty of £5 is payable on the form (if the shares are cancelled) or the stock transfer form (if the shares are in certificated form and are sold or transferred), as the transaction is treated as a conveyance or transfer otherwise than on sale. If the transfer is to a person whose business is issuing depositary receipts or providing a clearance service duty is charged ad valorem at 1.5%.

Financial Services and Markets Act 2000

As it was envisaged that companies would use treasury shares to deal in the market-place with greater flexibility and more often, the regulated activities regime under the Financial Services and Markets Act 2000 was modified to counter the possibility that a company might be deemed to be carrying on regulated activity simply by reason of the frequency of its treasury shares dealings. Financial promotion, however, is potentially a concern: while communications relating to its shares to its own shareholders are covered by an exemption, and should not be problematical when shares are being bought-in, selling treasury shares to buyers who are not already shareholders requires careful use of other exemptions if the expense of using an authorised person is to be avoided.

Takeovers

The Takeover Code excludes treasury shares in determining various thresholds, such as in the 1% shareholders disclosure of dealings provisions, and the level at which a mandatory bid is triggered.

Unless an offer is made for them, treasury shares are not counted as shares subject to a takeover offer for the purpose of calculating whether the offeror has achieved the 90% threshold needed to invoke the compulsory purchase provisions of Part 13A of the Companies Act or (where the Takeover Directive applies to the offer) Schedule 2 to the Takeovers Directive (Interim Implementation) Regulations 2006, and an offer will qualify as a takeover offer for this purpose even if it is not made in respect of treasury shares. Following the announcement of a firm intention to make an offer the company must on request provide the offeror with details of any shares held in treasury and of any arrangements to sell or transfer them. The offeror can extend the offer to shares that cease to be treasury shares before a date determined in accordance with the terms of the offer, but offering for the shares as treasury shares may be problematic, since they must be sold for cash and may be subject to pre-emption rights.

The Takeover Code also prohibits the company:

- from accepting an offer in respect of treasury shares until the offer is unconditional as to acceptances (which prevents the company from using the shares to treat an offeror preferentially where there are competing bids); and
- from transferring shares out of treasury during the course of an offer, or if it has reason to believe that a bona fide offer might be imminent, without the approval of shareholders in general meeting (although transfers of treasury shares to satisfy options exercised under an employees' share scheme established before the offer will normally be possible with the Panel's consent).

"…offering for the shares as treasury shares may be problematic, since they must be sold for cash and may be subject to pre-emption rights."

One factor weighing against the use of treasury shares for share schemes arises from the ABI's guidelines on share incentive schemes…

UKLA Listing Rules

Under the Listing Rules:

- the company is prohibited from selling or transferring treasury shares (other than non-equity securities whose price or value is unlikely to be significantly affected by publication of the information) during a close period or when it has inside information. There are certain dispensations corresponding to share scheme-related exemptions in the Model Code.
- the company must disclose sales and transfers into and out of treasury, any bonus shares held in treasury, and any cancellations of treasury shares or shares allotted as bonus shares by virtue of treasury shares – each time stating the proportion of treasury shares to other shares of the class.
- the discount at which treasury shares may be sold by way of placing, open offer or vendor consideration placing is limited to not more than 10% of the middle market price at the time of announcement of the offer or agreement of the placing, but this does not apply if the offer or placing has been specifically approved by the shareholders or is made under a pre-existing disapplication of pre-emption rights.
- the company's annual report and accounts must disclose the identity of purchasers of treasury shares sold (or proposed to be sold) off-market in connection with an employees' share scheme or otherwise than on a pre-emptive basis during the period under review.

In the Listing Rules treasury shares are usually excluded in the calculation of percentage thresholds (for example, in relation to the class tests for transactions). They are not taken into account when calculating the percentage of shares in public hands for the purposes of the test as to whether at least 25% of a class is held by the public.

The articles of association of many listed companies include power to impose sanctions on shareholders who fail to comply with a notice served under section 212 of the Companies Act. The Listing Rule prescribe the extent of this power, and allow certain additional sanctions if the relevant holding is greater than 0.25% of the relevant class, after discounting treasury shares. Companies whose articles pre-date the introduction of treasury shares may need to update the relevant article.

Employees' share schemes

The Listing Rules require a scheme that involves or may involve the issue of new shares or the transfer of treasury shares to be approved by shareholders before the scheme is adopted. Using treasury shares for a scheme already approved and adopted before treasury shares were introduced is potentially a fundamental change to the terms of the scheme. The change would require shareholder approval. The UKLA has said that re-approval would not be required where the scheme already allowed the use of both new and existing shares, and has told us that it would be the same if the scheme required only existing shares to be used. If, however, the scheme stipulated the use of new shares only, using treasury shares would require shareholder approval (perhaps by means of a simple resolution covering more than one scheme, accompanied by a brief explanation).

One factor weighing against the use of treasury shares for share schemes arises from the ABI's guidelines on share incentive schemes, which impose dilution limits (basically, not more than 10% of the issued ordinary share capital may be committed to schemes in any 10-year rolling period). The guidelines provide specifically that the use of treasury shares counts towards the 10% limit.

Two cheers for treasury shares?

There were high hopes of treasury shares, built on the fact that they were already a familiar feature in other jurisdictions and were often used by multi-nationals. But the restrictive framework of the UK regime – particularly in relation to the requirement to sell treasury shares on a pre-emptive

basis – was a disappointment, and some commentators felt that using treasury shares was hardly less cumbersome than a conventional buyback and fresh issue.

Nevertheless, even though the number of treasury shares that can be sold on a non-pre-emptive basis is restricted by the ABI guidelines, treasury shares do have attractions: for example, in enabling companies to take advantage of capital growth in their own shares by selling small numbers of treasury shares opportunistically, and in the fact that at least part (if not the whole) of the proceeds of sale of treasury shares is treated as realised profit. Despite the ABI share incentive scheme guidelines, they are being used in relation to employees' share schemes.

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"Treasury shares do have attractions… at least part (if not the whole) of the proceeds of sale of treasury shares is treated as realised profit."

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