C/M/S/ Cameron McKenna

Clearly corporate

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Contents

Not having to prepare a prospectus when offering awards to employees has undoubtedly contributed to the popularity of employee share schemes in the UK. But has the Prospectus Directive changed this?

Nicholas Stretch

Share schemes and the Prospectus Directive

The effect on employee share schemes

Offering shares to employees under employee share schemes has traditionally not involved any securities law issues in the UK, but the coming into effect of the EU Prospectus Directive (which for most purposes took effect here on 1 July 2005 through implementing legislation) has altered the underlying legal position.

In broad terms, the Directive requires the publication of a prospectus, and prescribes its contents, under two limbs:

- where there is an offer to the public of transferable securities, or
- where an application is made to admit transferable securities to trading on a regulated market (which includes the Official List but not AIM).

There are various exemptions, and offers to the public below a €2.5 million threshold, taking into account offers throughout the EU within the previous 12 months, fall outside the scope of the Directive completely.

Unlike the Public Offers of Securities Regulations 1995, which were repealed on 1 July 2005, neither the Directive nor the implementing legislation contains an automatic employee share scheme exemption. Offers to employees that are not within the €2.5 million threshold are therefore potentially public offers under the Directive, whether or not the securities are to be admitted to trading. If employers have to prepare a prospectus it is not hard to foresee that they might decide that the cost of operating employee share schemes outweighs the benefits, and stop operating them, or at least scale them back.

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Lobbying

When the Directive was passing through its EU approval process, ifsProShare and others lobbied hard for a complete exemption for employee share schemes, arguing that this would be consistent with the EU's aims of promoting employee share ownership. But

The regulatory authorities were initially reluctant to accept that free share schemes were by definition outside the scope of the Directive.

against the background of Enron and other scandals and the large employee losses that resulted, legislators thought that this was the time for more, not less, regulation.

After a period of uncertainty, a common position is emerging. Some (but not all) of the issues first feared are now - at least in the UK – turning out to be unfounded, so that many companies are able to continue to operate employee share schemes as previously. Some of the uncertainty has stemmed from poor and inconsistent drafting in the Directive. It is perhaps surprising that, even though the Directive was adopted in November 2003, it has taken so long for the European Commission and the UK Listing Authority publicly to issue their views on many of the points - in most cases only after the Directive has come into force. Indeed, even now many of these views have not been publicly circulated.

Option schemes

Most employee share schemes are option schemes: employees are granted, free of charge, options that are non-transferable (except in the event of death) and have an exercise price set at the prevailing market price at the time of grant (or with a small discount, as with SAYE options).

The key question, as far as obligations under the Directive are concerned, is whether an offer of transferable securities occurs. Is it necessary to look through the option to the underlying shares? If so, the employer might need to determine whether the €2.5 million threshold would be reached. That would mean adding the exercise price of the options to the value of any other shares offered in the last 12 months – but does one count back from the grant of the option or the date of exercise? As a company normally cannot choose when an employee exercises his option, it might find itself having to produce a succession of prospectuses without warning.

There now seems to be a consensus (approved by the UKLA and the European Commission) that the Directive does not apply at all to options. The offer to consider here is the offer of options (which are not transferable securities within the meaning of the legislation), and there is no offer of the underlying securities either at the point of grant or the point of exercise. This means that the grant of options should not give rise to UK prospectus issues, whatever the size of the option award, or whether an EU listed or other company makes the offer.

Free share schemes

Most other commonly seen employee share scheme are free share schemes, under which free shares are transferred to employees either at the time of the award (in which case they may be forfeited if the employee leaves within a certain period or targets are not met) or are transferred to the employee at the end of a service period if performance targets are met. The schemes come under a variety of names but would include long-term incentive plans (LTIPs), performance share plans and also the free and matching share components of the Revenue-approved share incentive plan (SIP).

The relevant legislation defines an offer to the public as a communication setting out sufficient information about the securities and the terms on which they are offered to enable an investor to decide to **buy** or **subscribe** for them – in other words, by implication requiring that something must be paid for the securities. The regulatory authorities were initially reluctant to accept that free share schemes were by definition outside the scope of the Directive. It was argued, for example, that:

- the employees were providing services for these shares, and this could amount to consideration (however difficult to value)
- references to specific exemptions for bonus shares in the Directive implied that free shares were generally caught
- while the UK version of the Directive refers to **consideration** of under €2.5 million, versions of the Directive in other languages refer to share offers with a **value** of under €2.5 million, so that a free share award of shares worth, say, £350,000 would have a value of £350,000 even if there were no consideration.

But, although no formal guidance has confirmed this, the European Commission and the UKLA are now understood to accept that in the UK the test is whether the **consideration** for the securities, not their **value**, is less than €2.5 million. Therefore, free share awards are excluded from the prospectus requirement, whoever makes the award.

Share acquisition schemes

Following the introduction of share incentive plans in 2000, many companies introduced the partnership share element of the SIP. This allows employees to save up to £125 each month and acquire shares (either monthly or at the end of the year) with their savings, with the shares being held in trust for a period.

The position of these schemes under the Directive is more complicated. The partnership shares are clearly not free shares, but are they analogous to options? It helps, for example, that the employee can withdraw at any time (although this has more force when he is entitled to acquire shares at the end of the year rather than the end of the month). This argument has not found much support, however – which is hardly surprising. After all, any offer could be said to be an option or could be structured by way of an option.

There may be other ways of escape from the public offer prospectus requirement:

- A company already operating partnership SIPs as at 1 July 2005 might argue, for example, that, so long as it refrains from periodic general communications about the SIP with all employees, it would only ever make a SIP offer to new employees whom it specifically told about the SIP. Valuing the securities being offered to new employees would be difficult (as often the SIP continues indefinitely until the company or individual withdraws from it), but since the maximum amount that an employee could save in a year is set at £1,500 the new joiners would be unlikely to break through the €2.5 million annual threshold (although any other offers to the public in the last 12 months, whether or not they related to the SIP, would also have to be included). This route is unlikely, however, to be feasible for new SIPs.
- The SIP might use existing shares, bought to the employees' order on the market, instead of newly-issued shares. On that basis, there would merely be an offer to buy shares on the employees' behalf, not an offer setting out sufficient information about the shares and the terms on which they are offered to enable an investor to decide to buy shares from the company or **subscribe** for them, within the meaning of the legislation.
- There is an exemption where the offer is made to fewer than 100 persons in any one EU member state.
- There is an exemption for EU listed companies (which does not include AIM companies), which can offer securities to their employees without producing a prospectus as long as a short document detailing basic information (and which might merely cross-refer to a website) is made available. According to one reading of the exemption, offers can be made where **any company in the group** has a listing of debt or shares, so a US listed company with a Luxembourg debt listing, for example, could take advantage of the exemption for share offers to its employees. However, the UKLA is known not to agree with this approach.
- It may be possible to argue that shares in private companies are not caught, on the grounds that they are not transferable securities within the meaning of the Directive. The definition (adopted from the Investment Services Directive) refers to securities that are "negotiable on the capital market". The ordinary meaning of this appears to exclude British private companies, which are prohibited under the Companies Act from offering securities to the public. The European Commission, on the contrary, was understood to consider any security capable of being traded (whether or not on a public platform) to be within the definition. There may, however, be a middle way if appropriate restrictions on transfer are included in the company's articles of association.

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Admission to trading

Even if it is possible to avoid producing a prospectus under the public offer requirement, a prospectus may be required if the shares arising on exercise of an option or issued by the company are to be admitted to listing.

Exemptions may be available to EU listed companies: for example, the issue may represent an increase of less than 10% (in aggregate over the previous 12 months) of an existing class, or the company could take advantage of another exemption by giving the employees a short document with details of the shares (which in many cases could simply refer to the company's website).

Outside the UK

Under the Directive, member states are free to impose national provisions even if the offer is outside the scope of the Directive or the offer is under €2.5 million. The UK has chosen not to regulate this area, but particular care must be taken in each non-UK jurisdiction, as it appears that various member states are imposing regimes for public offers below €2.5 million, or are taking positions on the Directive contrary to those described above taken by the UKLA or the European Commission.

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When buying or selling shares or businesses, what is effective disclosure for the purposes of a warranty claim? The Court of Appeal has unsettled some key assumptions by reversing the trend of a series of cases

James Grimwood

It depends what you mean by "disclosed"

Disclosure

In a share or asset purchase transaction, the law provides little protection as to the nature of what is being bought. It has therefore become the norm for the documentation to contain extensive contractual statements (known as warranties) about the subject matter. Warranties provide the buyer with a remedy if any of them turn out to be untrue or misleading, and also direct the seller's mind to specific areas in order to draw out information. This is especially important in share transactions, where the buyer will often be taking on the company warts and all (unlike an assets purchase, where there is more scope to cherry-pick and leave liabilities with the seller).

UK practice is rather idiosyncratic, in that, on their face, the warranties typically describe an ideal state of affairs (sometimes modified by "*so far as the seller is aware*"). But everything is to be understood as being subject to disclosures to the contrary made by the seller in a formal disclosure letter (usually accompanied by voluminous appendices in the form of a CD-rom or a bundle of documents). This method puts the onus on the seller to make sure that it has disclosed effectively: to the extent that it has not done so, it is taken to have given the warranty as stated. The question of what is (or is not) effective disclosure is therefore critical to the process. A series of cases over the last 25 years had established a consensus largely in favour of buyers, but in *Infiniteland Ltd v Artisan Contracting Ltd* the Court of Appeal has bucked the trend.

> *The courts tended not to place emphasis on the precise subtleties and shades of meaning in disclosure provisions.*

The established position

There is no precise formula for disclosure in transactional documents: some agreements say that the warranties are given "*except as disclosed*" or "*except as fairly disclosed*". Some require disclosures to be specific, full or accurate, and there are various permutations of these and other terms.

Until *Infiniteland*, it was generally thought that all the variations were really distinctions without a difference. The courts tended not to place emphasis on the precise subtleties and shades of meaning in disclosure provisions. The lack of elaborate wording was no impediment to the buyer in a case in 1978, for example, where the seller had warranted

> *The clear sign is that it is largely up to the parties to write their own rules, and that negotiating the wording is likely to be the subject of more intense focus between them.*

that, "*save as disclosed*", there had been no adverse change in the net assets of the business since the year-end. The buyer was given carte blanche to review all aspects of the business (and, indeed, appeared to have been involved in its affairs prior to exchange of contracts). He had certainly known that the business was loss-making, and had been given clear indications of the rate of the losses and that the negative impact on net assets was inevitable. Yet the court upheld his warranty claim, and said that "a protection by disclosure will not normally be achieved merely by making known the means of knowledge which may or do enable the other party to work out certain facts and conclusions." In other words, it was not enough that the buyer could have worked it out for himself: the precise amount of the reduction in net assets should have been disclosed.

Similarly, in a case in 1996, the court said that it was not enough merely to refer to a source of information where a diligent inquirer might find the relevant information. The judge condemned what he called the "repetitive and omnibus approach" of the seller deeming a whole series of documents to have been disclosed and seeking to rely on information contained in them as effective disclosures. But what has not received enough attention until now is that the agreement expressly required disclosures to be made "*with sufficient details to identify the nature and scope of the matter disclosed.*"

The Infiniteland case

Artisan sold three companies to Infiniteland. The year-end accounts of one of the companies showed a profit of almost £600,000. The sale and purchase agreement contained a warranty that the accounts showed a true and fair view of the financial position of the company, and the seller accepted that in fact they did not. This was due to an exceptional item of just over £1 million that had been incorrectly offset against the cost of sales, with the result that the profit and loss account was overstated. The company had in fact made a loss of just over £500,000.

The agreement qualified the warranties by the phrase, "*save as set out in the disclosure letter*", and the disclosure letter in turn was deemed to include all information supplied to the reporting accountants. It was through a bundle of files sent to the accountants that the seller sought to pin the disclosures on the buyer. The files do not appear by any means to have contained a full explanation of the accounting irregularity or its artificial effect on profits, but there was enough information to alert the reporting accountants. One of them did unearth the issue, raised a query with the seller and was told the true position. But this material fact was not reported to the buyer in the accountants' due diligence report.

The Court of Appeal – reversing the High Court – found that there had been valid disclosure and therefore no breach of warranty. In the leading judgment, Lord Justice Chadwick emphasised the need to focus on the precise language of the agreement. In doing so, he neatly turned the 1996 case, which had previously been seen as confirming the buyer-friendly trend, to his purpose, pointing out that it had been decided not on a general principle of what proper disclosure meant but because the agreement had stipulated sufficient details to identify the nature and scope of the matter disclosed. He said that, if the Infiniteland agreement had expressly required disclosures to be full, clear and accurate (which was the standard the High Court had applied, regardless of the actual wording), he may well have agreed that there had not been valid disclosure. The clear sign is that it is largely up to the parties to write their own rules, and that negotiating the wording is likely to be the subject of more intense focus between them.

So what is the standard where the agreement provides for nothing more than bare disclosure? Lord Justice Chadwick said:

> *"the disclosure requirement was satisfied in relation to such matters as might fairly be expected to come to the knowledge of the reporting accountants from an examination (in the ordinary course of carrying out a due diligence*

> *exercise for which they were engaged) of the documents and written information supplied to them."*

The standard may differ depending on the recipient of the information: here, the test refers to the expected knowledge of reporting accountants, but that is because the agreement provided that everything supplied to the accountants was to be treated as disclosed. The buyer could have refused to accept this, but must be presumed to have chosen freely not to do so. If the agreement had been silent on the point, it is possible that the buyer's engagement of professional advisers would have led to the same standard being imposed. Conversely, if no experts are involved (or known to be involved), the standard of disclosure is presumably higher.

Relevance of the buyer's knowledge

The case also touches on another important issue: can the buyer make a warranty claim on the basis of information that was not formally disclosed by the seller but was nevertheless known to the buyer when it entered into the agreement? What if the agreement says that it can? Since 1991, when the Court of Appeal suggested (without deciding the matter) in a case known as *Eurocopy* that such a provision might not stand up, lawyers acting for buyers have continued to include these clauses but have warned their clients that they might not work.

The Infiniteland agreement provided that the buyer's rights and remedies in respect of any breach of the warranties were not to be affected by any investigation made by it or on its behalf into the affairs of the companies. But the clause contained a carve-out: the buyer's rights were not to be affected except to the extent that any such investigation gave the buyer actual knowledge of the relevant facts.

Most lawyers who routinely negotiate sale and purchase documentation were probably not surprised at the interpretation taken by the High Court: the clause might seem to be included principally for the buyer's benefit, but the effect of the carve-out was to flip it over, so that where any investigation gave the buyer actual knowledge of the relevant facts the buyer had no claim. The Court of Appeal disagreed: the clause was there to protect the buyer, and happened to include a carve-out for actual knowledge. That was not the same as an additional protection for the benefit of the seller enabling it to avoid liability where the buyer had actual knowledge. It is not clear, however, what the carve-out means in the Court of Appeal's reading, or what effect it would have in the context of a warranty claim. One possible interpretation is that, while the seller is agreeing not to invoke the buyer's investigations in defending a warranty claim, it is not agreeing to hold back where the investigation resulted in actual knowledge. In that event, the buyer is free to take proceedings, but the seller is free to argue that the quantum of damages should reflect the fact that the buyer was willing to buy at the agreed price despite knowing the relevant facts, and ought not to be allowed to try to improve the bargain.

Having already decided that disclosure had been effective, the Court of Appeal did not have to decide whether, as a matter of law, a buyer with actual knowledge is precluded from claiming for breach of warranty notwithstanding a clause expressly preserving such rights, or where the agreement is silent on the issue. The High Court believed that there was no such principle of law. Although the Court of Appeal left the matter open, it does seem likely that parties can agree that knowledge is irrelevant to the right to claim. But it is also likely that any buyer hoping to do so will encounter strong arguments along the lines referred to in *Eurocopy*: that it might be dishonest – even fraudulent – for the buyer to claim, or that the buyer's knowledge goes to the quantum of loss. It is therefore inadvisable for a buyer to "sign and sue". The matter should be raised before exchange and either factored into the price or covered specifically by an indemnity.

> *"Although the Court of Appeal left the matter open, it does seem likely that parties can agree that knowledge is irrelevant to the right to claim."*

…sellers should reduce the risk of failing to make a disclosure stick. Ensure that disclosures are as specific as possible and adequately bring the matter to the buyer's attention…

Imputed knowledge

On the question of the actual knowledge carve-out, the High Court thought that the knowledge of the reporting accountants could be imputed to the buyer (this was not relevant to the disclosure issue, as the agreement provided that what was supplied to the accountants counted as disclosed to the buyer).

The Court of Appeal disagreed, and said that the carve-out would have expressly referred to imputed knowledge had the parties intended the accountants' knowledge to be covered. This was dealt with fairly briefly in the leading judgment and does seem a slightly curious result. One of the judges, dissenting on this point, put it cogently: can the parties, who knew the information was being sent to the buyer's accountants for due diligence and expected them to report to the buyer, really have intended the seller to bear the risk that the buyer's accountants would be in default?

Practical measures

If acting for the buyer:

- Expressly provide for as high a standard of disclosure as possible in the agreement (for example, by requiring sufficient details to identify the nature and scope of the matter disclosed).
- Be cautious of general disclosures. Sellers will go on seeking deemed disclosure of all due diligence or everything contained (or, even, referred to) in disclosure documents, particularly where the documents have been available for a prolonged period. If the buyer concedes, it is all the more important to insist that deemed disclosures provide sufficient details to identify the nature and scope of the relevant matters.
- Be ever more alert to last-minute disclosures. There may simply not be enough time or the will to assess the full implications of the disclosure. Time can be even tighter if the information is being supplied directly to advisers (who may even have signed off their reports by then).
- Include a clause asserting that the buyer can claim (not merely that its rights and remedies are not affected) notwithstanding its knowledge (actual or imputed, or what it might reasonably be expected to discover), and consider providing that – in the absence of fraud on the buyer's part - the quantum of damages will not be affected by any such knowledge. But stress to the buyer that these provisions may not work in all situations. If the buyer knows about something prior to exchange, seek an indemnity or a reduction in the price.

If acting for the seller:

- Maximise the scope of disclosure by resisting any formula more rigorous than "disclosed" or "fairly disclosed".
- Include an acknowledgment in the disclosure letter that specialist advisers of the buyer have been supplied with the information, in case the court infers a greater onus on the seller to bring out the issues.
- As always, sellers should reduce the risk of failing to make a disclosure stick. Ensure that disclosures are as specific as possible and adequately bring the matter to the buyer's attention in the disclosure letter, giving the buyer and its advisers as much time as possible to consider the information.
- Address the effect of the buyer's knowledge on warranty claims: for example, by a cross warranty that the buyer is not aware of any breach of warranty. Spell out that the buyer is not entitled to make a claim based on its actual knowledge of the relevant facts before the agreement was exchanged. Specify whose knowledge in the buyer's organisation counts as the buyer's knowledge, and whether the advisers' knowledge is included (bearing in mind that the courts appear to be slow to impute advisers' knowledge to the buyer in the absence of express provision).

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The long-awaited new TUPE Regulations, along with the Government's response to the public consultation, have now been published by the DTI along with new guidance

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The Transfer of Undertakings (Protection of Employment) Regulations 2006

The reform of TUPE is long overdue. As we reported in *Clearly Corporate* in June 2005, the consultation that had then been recently published reflected policy decisions already taken as a result of a consultation in 2002/3.

The new regulations affect transfers occurring on or after 6 April 2006, less than eight weeks after publication, so there has not been much time to prepare. The intention is to improve and simplify the operation of transfers without prejudicing employees and to take advantage of some additional flexibilities afforded by the revised version of the Acquired Rights Directive. It remains to be seen whether the revised regulations will improve matters.

"The new regulations affect transfers occurring on or after 6 April 2006, less than eight weeks after publication, so there has not been much time to prepare."

The scope of the regulations

Regulation 3 defines a "relevant transfer" for the purposes of TUPE. This definition includes a so-called "service provision change" (in other words, outsourcing and insourcing) and the word "activities" is used as a broad term to cover the nature of the service provision. There is no requirement, or implied requirement, for those activities to be carried out by the transferee in an identical manner, although other (non-service provision change) transfers still need to retain their identity to fall within TUPE's scope.

The regulations have introduced a new "code" in relation to service provision transfers for deciding which employees transfer. This concept arguably ousts existing case law.

The consultation invited views on whether professional business services should be carved-out, but the Government decided against making an exception.

"The regulations create a new right for employees who suffer a substantial change in working conditions to their material detriment as a result of the transfer to claim constructive unfair dismissal…"

The impact on contracts of employment

Regulation 4 sets out what happens to contracts on a transfer. These continue in the same way under the transferee employer as they operated under the transferor employer. Regulation 4 clarifies that any alteration of the terms of an employment contract because of the transfer itself will be void, although changes may lawfully be made for an economic, technical or organisational (ETO) reason *entailing changes in the workforce* which is transfer-connected. Emphasis, of course, remains on the reference to entailing changes in the workforce, where existing extensive case law retains full force.

Many responses to the consultation tried to persuade the Government to allow agreed changes to terms and conditions to be valid (provided the employee was left no worse off overall). However, the Government has concluded that this would be incompatible with the Acquired Rights Directive (as interpreted by the European Court of Justice). Instead, it intends to pursue this policy objective by pressing for the Acquired Rights Directive to be amended to permit this.

Dismissals and redundancies

The regulations create a new right for employees who suffer a substantial change in working conditions to their material detriment as a result of the transfer to claim constructive unfair dismissal (but not pay in lieu of notice). This is a potentially far-reaching change, even though there is no presumption of automatic unfairness in such a case. "Working conditions" have not been defined. The only example given in the accompanying guidance is a workplace relocation or loss of academic tenure. As the former would be a redundancy in any event, and the latter is most rare, the guidance is not as illuminating as it might be. The lack of compelling examples makes the need for this potentially very significant change seem rather questionable, but time will tell.

Regulation 7 covers the situation where employees may be dismissed because of a transfer, or for a reason connected with a transfer. It provides for a dismissal to be automatically unfair where:

- it was made by either the transferor or the transferee employer because of the transfer itself, or
- for a reason connected with the transfer which was not an ETO reason entailing changes in the workforce.

Dismissals could be fair where the reason for the dismissal was unconnected with the transfer or was an ETO reason connected with the transfer entailing changes to the workforce. In the guidance the Government has provided some advice to assist in understanding whether such a reason will make a dismissal fair. It explains that, if there is such a reason and it is the cause or main cause of the dismissal, the dismissal will be fair as long as the Employment Tribunal decides that the employer acted reasonably in the circumstances in treating that reason as sufficient to justify dismissal, and that the employer met the other requirements of the general law on unfair dismissal. It also points out that the onus is on the employer to show that the dismissal falls within the ETO exemption to the automatic unfairness rule, and that the courts and tribunals have not generally sought to distinguish between each of the three ETO categories, but rather have treated them as a single concept.

Insolvency

Regulations 8 and 9 are intended to encourage the rescue culture. They deal with the situation where a relevant transfer occurs while the transferor employer is in administration.

Regulation 8 concerns the pre-existing debts owed by the transferor to those employees who transfer. It ensures that those debts do not pass to the transferee to the extent that those employees are entitled to receive payments from the Secretary of State under the so-called insolvency guarantee (eight weeks' arrears of pay up to £2,320 and six weeks' holiday pay up to £1,740 per employee). Debts in excess still pass over to the transferee.

Regulation 9 provides for the transferor, administrator or transferee to agree permitted variations to terms and conditions with collective representatives of the employees only – not individually – and only where any such change is designed to safeguard employment by ensuring the survival of the transferred undertaking.

Both these changes are useful.

Notification of employee liability information

Regulation 11 establishes a new duty on the transferor to provide information in writing to the transferee in advance of the transfer about certain rights, powers, duties and liabilities under the contracts of those employees who are due to transfer.

The prime purpose of the duty is to enable the transferee employer to plan for the arrival of the new employees and fully to assess the liabilities and obligations he will inherit. It is not designed to assist in any tender process, and the Government has therefore required the information to be supplied to the transferee only, rather than to trade unions or to all contractors who tender for the contract.

The regulations identify the categories of information that must be supplied. These are:

- the identity and age of the employee
- those particulars of employment that an employer is obliged to give to an employee pursuant to section 1 of the Employment Rights Act 1996
- information about disciplinary or grievance procedures taken within the previous two years in circumstances where the Employment Act 2002 statutory dispute resolution procedures apply
- information about any court or tribunal case, or any claim or action, brought by an employee against the transferor within the previous two years, or relevant information where the transferor has reasonable grounds to believe that an employee might bring any such action against the transferee
- information about any collective agreement which will have effect after the transfer.

The parties cannot contract out of this list of obligations but indemnification for the underlying transferred obligations is still possible.

Although the requirement to identify employees and provide detailed personal information may seem to conflict with the guidance in the Employment Practices Data Protection Code (which, for example, advocates anonymised information), the fact that these requirements are set out on the face of the regulations should – according to the DTI – ensure that complying with them cannot be a breach of the Data Protection Act 1998.

The regulations require the information to be given not less than 14 days before the relevant transfer unless "special circumstances" make this not reasonably practicable (in which case the information must be given as soon as reasonably practicable), and the information must not be more than 14 days out of date. The guidance gives, as examples of special circumstances, when the transfer takes place at very short notice or where the transferor does not know the identity of the transferee until very late in the process (a real possibility bearing in mind the extension of scope to service provision changes).

Most significantly, the transferee can claim for compensation in the Employment Tribunal where the transferor is in default, and will be entitled to not less than £500 from the transferor for each employee for whom the information was not provided. The Employment Tribunal will, however, have discretion to award a smaller sum where it thinks it "just and equitable" to do so – for example, for a trivial or unwitting breach, according to the guidance.

No attempt is made to define when a "transfer" takes place, which is now a critical question. The decision in the case of *Astley v Celtec Ltd*, due for hearing shortly in the House of Lords, will be crucial to understanding this aspect, which may well prove to be problematical.

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> *The Government has provided for joint and several liability in respect of any award made by the Employment Tribunal if the transferor fails to inform and consult.*

Under transitional provisions, the duty to provide employee liability information does not apply in the case of a relevant transfer taking place on or before 19 April 2006.

It remains to be seen whether this duty will materially add to the burdens on a transferor, given that so much information is required to be disclosed in practice in many transactions.

Informing and consulting representatives

Regulations 13 to 15 now deal with the duties on both the transferor and the transferee to inform representatives of their respective affected employees about the transfer and to consult with those representatives about matters relating to the transfer in the same terms as before.

The Government has provided for joint and several liability in respect of any award made by the Employment Tribunal if the transferor fails to inform and consult. This ensures that both the transferor and the transferee should have a clear incentive to comply. The Tribunal can therefore apportion liability between the parties according to fault under the Civil Liability (Contribution) Act 1978. This is a worthwhile change, reversing the unfortunate effect of *Kerry Foods v Creber* and *Alamo Group v Tucker*, which held that all this liability was for the transferee's account even though the duty to inform the transferring workforce fell on the transferor.

Under transitional provisions, regulations 13 to 15 do not apply in the case of a service provision change that is not also a transfer of an undertaking, business or part of an undertaking or business that takes place on or before 4 May 2006.

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The European Commission is consulting on enforcement of the prohibition on abuse of a dominant position. It was hoped that this complex area was about to be made more amenable, but the discussion paper is hardly promising. Life has just got harder, too, for parties contemplating mergers: the Office of Fair Trading has stopped giving confidential guidance

John Markham

Liz Moore

Competition developments

Abuse of dominant position

The European Commission has recently published a "Staff Discussion Paper" for consultation on the EU prohibition on abuse of a dominant position. This area has been the subject of much speculation by businesses, lawyers and economists.

"Principally, Article 82 regulates the prices a company with a 40%+ market share sets its customers."

There are two fundamental prohibitions under competition law:

- **Article 81** of the EC Treaty prohibits anti-competitive agreements, i.e. business arrangements involving two or more distinct undertakings.
- **Article 82** of the EC Treaty prohibits the abuse of a dominant position, i.e. anti-competitive unilateral conduct on the part of companies with a strong market position.

The Article 82 regime is the subject of the discussion paper.

When considering what is regarded as a "dominant position", at a 40% market share a company is very likely to be found dominant. At 50%, dominance is assumed. Principally, Article 82 regulates the prices a company with a 40%+ market share sets its customers.

Expected reform

It is interesting to compare the enforcement of the two prohibitions.

The Article 81 prohibition has for a number of years been regulated by a system of market share thresholds through so-called block exemption regulations backed up by exhaustive interpretative guidelines. There are block exemptions for both horizontal agreements (between competitors) and vertical agreements (supply agreements between non-competitors). Although

> *Exploitative abuses such as discrimination and excessive pricing are to be the subject of further work by the Commission in 2006.*

the Article 81 regime can be complex, businesses have on the whole found it to be economically realistic in exempting clearly minor restrictions from competition law scrutiny and in allowing the competition authorities to concentrate on more serious infringements.

The enforcement of the **Article 82** prohibition is a different story. Exemption is not a possibility under Article 82 and the European Commission's approach to what constitutes abusive conduct has often been considered excessively strict. In effect, many pricing schemes which companies regard as normal business practice are automatically banned if carried out by a "dominant" company, no matter whether the relevant supplier's market share is 45% or 95%, and whatever the circumstances of the supplier and its customer in relation to negotiating power or competitive pressure. This is arguably true of loyalty or target rebates, below-cost selling, exclusivity or requirements contracts imposed by dominant suppliers or obligations to purchase a range of products (so-called bundling or tying).

It had been anticipated that the Commission might introduce a reform of Article 82 enforcement to complement the reform of Article 81 of a few years ago. Although exemption as such is impossible, nonetheless business has recently pressed the Commission for either or both of two things: the introduction of some form of market share benchmark (so that, for example, companies only just above the 40% benchmark, or practices only covering a fraction of the market, could benefit from a more liberal approach); or the introduction of very clear and realistic tests to determine exactly when the pricing practices listed above are truly abusive.

The methodology

It had been hoped that the discussion paper might consolidate all of the EU's previous case law relating to dominance into one single coherent theory. The European Commission says that the discussion paper "sets out one possible methodology for the assessment of some of the most common forms of abusive practices, such as tying, and rebates and discounts". In fact, the methodology consists of little more than a non-committal declaration that, the higher the dominant market share and the greater the market coverage, the more chance there will be of an abuse; and of various economically complex tests to determine the actual foreclosure of competitors.

In other words, there are no clear-cut thresholds or easy-to-use tests. The general reaction from the legal and business communities has been that companies will find the methodology vague and that, after all the anticipation, it fails to provide a clear message.

Is serious reform likely?

The Commission will decide how to proceed once it has received comments from the public on the discussion paper. It had been thought that the Commission would publish guidelines on the application of the Article 82 prohibition, but it appears to have stepped back from this idea, stating that it is "too early to say" whether the discussion paper will eventually become Commission guidelines. It seems a real possibility that – other than publishing an open-ended declaration of its general policy in a format similar to the discussion paper – the Commission may end up initiating no substantive reform of its Article 82 enforcement policy. It is clear, however, that the Commission wishes to promote a wide-ranging public debate on the concept of abuse of dominance, and it notes that "dominant companies should be allowed to compete effectively."

The discussion paper studies only exclusionary abuses, which exclude competitors from the market. Exploitative abuses such as discrimination and excessive pricing are to be the subject of further work by the Commission in 2006.

The Commission has drawn attention to how the discussion paper may help to promote private claims for damages in national courts due to breach of EU competition law. It notes that the discussion paper should help national courts deciding on private damages cases by identifying which elements of evidence in a particular case are relevant, and by determining the relative importance of those elements. The Commission has also just published a green paper on private enforcement of competition law.

If you have views on this subject, you can make them known by responding to the consultation and adding to the debate. The text of the discussion paper is available at: http://europa.eu.int/comm/competition/antitrust/others/discpaper2005.pdf.

OFT confidential guidance and informal advice

The Office of Fair Trading has taken a surprise step by suspending until further notice the provision of confidential guidance or informal advice to parties considering a merger. Surprisingly, there was no formal press release; instead, the news filtered through after a speech by OFT Chairman Philip Collins was published. Many competition lawyers were surprised that such an important step had been made without any consultation or formal notice. Philip Collins said in the speech that the decision to suspend the services was due, at least in part, to "heightened expectations at a time of increased caseload."

Under both confidential guidance and informal advice, the OFT would give a view on whether it was likely to refer a particular transaction to the Competition Commission for in-depth review. Confidential guidance was the more formal procedure. Both procedures would take place before the particular transaction was in the public domain. This meant that the OFT would give its view before it could know the views of third parties, such as the merging parties' customers or consumers. Recent appeals of OFT merger decisions have emphasised the importance of the OFT taking into account third party comment in its merger decision-making process.

Confidential guidance and informal advice were popular with parties considering mergers, who welcomed a chance to sound out the OFT before committing themselves to a particular deal. Being able to get a preliminary view from the OFT often gave parties the confidence to take on deals they might otherwise have shied away from and, conversely, if the news from the OFT was bad the parties had a chance to save time and money by not proceeding.

Why has the OFT taken this step?

- The move appears to be motivated by increased pressure on the OFT's resources, caused by a recent upturn in merger activity and more work being required on individual cases. Recent merger appeals have clarified that the threshold for referring cases to the Competition Commission is lower than the OFT had originally thought. Those appeals also highlighted insufficient reasoning and evidence to support OFT conclusions. This has all meant that the OFT now scrutinises cases more thoroughly and requires more evidence from the parties than previously - all of which takes more time and resources.
- Parties have over the past few months felt less able to rely on confidential guidance or informal advice, as the OFT has consistently stressed the influence of third parties in its decision-making process. It has been suggested that over 20% of cases in which the OFT said it was unlikely to refer the case were eventually referred to the Competition Commission, and that, in a number of cases where the OFT said it was likely to refer, the case was eventually cleared.
- There has been a growing feeling among users of the system that both confidential guidance and informal advice procedures had become much longer and more involved than a few years ago, often taking up almost as much time, effort and resources as making a formal merger notification to the OFT.
- The OFT has many statutory duties that, obviously, it cannot suspend, such as scrutinising merger control notifications, and reviewing the relevance of undertakings and orders accepted in competition cases. The OFT is under no statutory duty to provide either confidential guidance or informal advice, so this was an area where it was at least possible to cut back.

> *"Confidential guidance and informal advice were popular with parties considering mergers, who welcomed a chance to sound out the OFT before committing themselves to a particular deal."*

It will be very important to gauge likely third party reaction to proposed transactions and devise strategies for dealing with unfavourable comment.

What happens now?

The OFT has said that it intends to undertake a public consultation early in its next financial year (beginning April 2006) on the long term position on provision of these services. In the interim, confidential guidance will not be provided at all and informal advice only in pro bono cases where the requesting party is unable to afford external competition law advice. Exceptions may be possible but are likely to be rare.

"Focused" pre-notification contact with the OFT will continue to be possible. Pre-notification concentrates on practical matters concerning transactions that are close to being concluded, such as timing and format of notifications and agreeing whether a draft notification's scope, level of information, reasoning and other aspects are adequate.

Impact on potential merger activity

At least until the end of the consultation period (probably around summer 2006), the OFT sounding board is no longer available. It will be up to parties and their advisers to form a view on the likelihood of being referred to the Competition Commission. This will emphasise the need to obtain clear evidence of the competitive benefits of possible transactions. It will also be very important to gauge likely third party reaction to proposed transactions and devise strategies for dealing with unfavourable comment.

It also appears very unlikely that the OFT would consider jurisdictional questions with merging parties unless a notification is made. This raises particular issues when considering transactions where market definition is unclear or where it is unclear whether a transaction would meet the share of supply test (and thus be subject to UK merger control). This is going to make life more difficult for parties considering mergers, as it will become even more important for them to understand thoroughly the markets potentially relevant to a merger before agreeing merger transactions.

The text of the OFT's current position on confidential guidance and informal advice is available at http://www.oft.gov.uk/NR/rdonlyres/AA1711C5-41BB-4551-B27B-5A858E3E0417/0/mergersinformal.pdf.

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Three new laws reforming German securities law are intended to restore investor confidence in the integrity, stability and transparency of the stock markets

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Modernisation of German securities law

Three new statutes are designed to rid German listed companies of two related problems perceived to have been highly damaging to investor confidence over many years:

- "raptorial shareholders" - taking advantage of the fact that lodging a claim to set aside shareholder resolutions prevented the resolutions from taking effect, unscrupulous shareholders have become adept at exploiting shareholders' meetings for their own economic advantage, using disruptive and filibustering tactics to bully the directors and provide artificial grounds for claims. Companies attempting fundamental structural changes have been especially prone to this form of blackmail.
- shareholder apathy - as a corollary, many shareholders no longer bother to attend shareholders' meeting or to make their views known. As a result, whether fairly or not, directors and supervisory board members can come to seem more focused on their own interests than those of the shareholders, particularly in their management of the company's assets.

Improving attendance at shareholders' meetings

Previously, a shareholder's right to attend and vote at a shareholders' meeting usually depended on his depositing his shares well before the meeting. This often led foreign institutional investors in particular to believe – mistakenly – that their shares could not be sold while they were on deposit. It followed that some shareholders, particularly if they had large holdings, preferred to forego their right to attend meetings rather than (as they supposed) freeze their right to sell.

Under the new **Company Integrity and Modernisation of the Right of Avoidance Act** (*Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts*) (**UMAG**), however, shareholders only have to register to attend meetings (and, if they hold bearer shares in listed companies, provide proof of ownership through their depositary bank as at the record date, which is 21 days before the meeting). Shareholders can still attend meetings even if they sell their shares after the record date, so there can be discrepancies between share ownership and the right to attend. Anyone buying a large holding of bearer shares in the 21 days before the meeting should therefore get written assurance from the seller that he will exercise the voting rights in accordance with the buyer's instructions.

"…unscrupulous shareholders have become adept at exploiting shareholders' meetings for their own economic advantage, using disruptive and filibustering tactics to bully the directors and provide artificial grounds for claims."

> …the chairman can ensure that the meeting does not usually last more than between four and six hours.

Running the shareholders' meeting

Under German law, every shareholder attending the meeting is entitled to request information on the company's affairs to the extent necessary to form an objective view of the topics on the agenda, and to address the meeting.

This, of course, has laid companies open to raptorial shareholders. Resolutions passed after midnight on the day of the meeting are of no effect, so a shareholder determined to prolong the meeting by launching into long-winded speeches and producing interminable lists of questions could bring very real pressure to bear on the directors. The situation was made worse by the fact that interrupting a speaker or any failure by the directors to answer questions fully could give the shareholder grounds for a legal challenge.

Under the UMAG:

- the board may post information on frequently asked questions on the company's website. If this information has been continually accessible on the website at least seven days before the beginning of the meeting the board can refuse to provide information on these questions in the meeting.
- shareholders can adopt a provision in the company's articles of association authorising the chairman to impose a reasonable restriction on the time available to shareholders for speaking and asking questions. In this way, the chairman can ensure that the meeting does not usually last more than between four and six hours.

It remains to be seen whether these measures will succeed in reducing the length of shareholders' meetings and provide a forum for shareholders to exchange views. In the past, raptorial shareholders have usually managed to get round any restrictions directed against them.

Action to set aside/ release procedure

There are new restrictions on the ability to file claims to set aside resolutions passed at shareholders' meetings. Those who spotted a lucrative chance to file such a claim used to be able to buy shares just before a meeting. Under the new law, a shareholder may only file this type of action if he bought the shares before the agenda was published.

The legislation includes what is known as a release procedure (*Freigabeverfahren*). If an action to set aside is filed against a capital increase resolution or a resolution consenting to an intra-group agreement (in particular, a control and profit transfer agreement, i.e. an agreement by which a listed company submits the management of the company to another enterprise and undertakes to transfer its profits to that other enterprise), the court may, if the company files an application in fast-track proceedings, rule that the action to set aside will not prevent the resolution from being entered in the commercial register (in other words, from taking effect). This type of order is only possible, however, if the action is inadmissible or obviously unfounded, or if the company's interest in the resolution is deemed to take priority over the interest of the shareholder who filed the action.

The UMAG also provides, as a disincentive to raptorial shareholders (and the board, too, perhaps), that any settlement of an action to set aside must be published, along with details of any payments made or promised.

Directors' and officers' liability

In a change designed to boost the entrepreneurial initiative of board and supervisory board members and promote a greater willingness to take decisions, the UMAG expressly incorporates the business judgement rule into securities law, which the courts have already applied in past cases. If directors and officers meet certain tests they are not liable for errors of business judgement.

The rule applies to directors' decisions if they qualify as entrepreneurial decisions that relate to future developments and are, therefore, based on forecasts (i.e. estimations that cannot be verified by a court), and if the action taken:

- is based on reasonable information. The need for information must be judged individually according to the type and significance of the transaction in question, the time available for making the decision and the chances and risks associated with it
- serves the good of the company, i.e. aims to increase its earnings capacity and its competitiveness
- is not driven by special interests or external influences, and particularly not by the individual interests of directors and officers
- is taken in good faith.

The business judgement rule applies only to entrepreneurial decisions, and not to breaches of duty arising from statute, the articles of association or supervisory board resolutions.

Making claims against directors

As a rule, only the company, not the shareholders, can make liability claims against directors and officers. The UMAG has not changed this, but it has changed the system under which claims against directors had to be filed by the supervisory board and claims against the supervisory board had to be filed by the directors – a rare event in either case, no doubt due in some cases to the closeness built up between the two boards. This is likely to change in future.

Under the UMAG, shareholders can file the company's claims for compensation directly against directors and officers as long as the following conditions are met in preliminary proceedings:

- the relevant shareholders hold in aggregate at least 1% of the share capital, or a nominal amount of €100,000 of the share capital
- they bought their shares before the time when they should have been aware of a potential claim for compensation based on published information
- the company has not filed a claim itself despite a reasonable period being set
- there are no overriding reasons associated with the good of the company that preclude a claim for compensation, and
- there are circumstances which justifiably suggest that the company has suffered a loss as a result of a lack of integrity or gross breach of the law or the articles of association.

As shareholders can contact one another through the so-called shareholders' forum on the internet with a view to filing an application, and raptorial shareholders are known to have bought shares in all listed German companies in anticipation of the UMAG, only the last of these conditions protects directors and officers from being swamped with liability claims. A court will only admit a liability claim against a director or officer if it considers that the director or officer has committed a serious breach of duty. But the expected volume of these preliminary proceedings alone is likely to hinder directors and officers in their work.

Appointment of a special examiner

German securities law enables shareholders to have certain business procedures examined by a special examiner, who has comprehensive investigatory and inspection rights. If the shareholders in a shareholders' meeting decide by a majority to reject an application to appoint a special examiner the minority can instead apply to the court to have a special examiner appointed. In the past, this required the application to be filed by holders of at least 10% in aggregate of the share capital or a nominal amount of €1,000,000 of the share capital, but under the UMAG holders of 1% in aggregate of the share capital or a nominal amount of €100,000 of the share capital can apply. As shareholders can use the shareholders' forum on the internet to rally support for an application, the new threshold will hardly be an effective way of restricting special examinations.

The court will allow an application to appoint a special examiner if:

- the applicants held their shares for at least three months before the date of the meeting at which the application to appoint the special examiner was defeated, and
- there are circumstances that suggest

> *"German securities law enables shareholders to have certain business procedures examined by a special examiner, who has comprehensive investigatory and inspection rights."*

The revised law requires listed companies to state, against the name of each director, the entire remuneration paid to him.

with some justification that the directors have acted without integrity or are in gross breach of the law or the articles of association.

There is likely to be a sharp increase in the number of special examinations, at least in cases of serious breach of duty. The results of the examination, published in the special examiner's report, may form the basis for subsequent liability claims against the directors or officers.

Test cases

Until recently there has been no German equivalent to the US-style class action. If a large number of investors suffered losses as a result, say, of a company's failure to disclose information to the market, the German courts were flooded with individual claims, each of which had to be processed and decided on its own merits at a great cost of time and money to the claimants and the courts.

The new **Capital Investor's Test Case Act** (*Kapitalanleger-Musterverfahrensgesetz*) (**KapMuG**) has introduced the concept of a test case into German securities law and civil procedure. The Act will run for a five-year trial period, and is already being applied in a prospectus liability case against the German telecommunications company, Telekom AG, on the grounds of alleged manipulation during the 1996 IPO. A total of 14,447 shareholders, represented by 754 lawyers, have filed claims.

The purpose of the new procedure is to bring about a "test case decision". This sets out the individual factual elements or legal issues, which are then legally binding in relation to all the claimants whose cases are linked to the test case. The individual proceedings are then continued on the basis of the factual elements or legal issues and decided independently.

The test case is initiated by an application filed by a claimant, and the application is published in a special claim register. If a further nine claimants file an application in the same matter, this sets the actual test case proceedings rolling. These are conducted by the higher regional court, which chooses one of the claimants as the test claimant. Until a decision – the test case decision – has been reached in the test case proceedings, other claims can be bound to the test case decision.

Once the test case decision has become final and absolute the courts will continue to process and take decisions on the individual cases. The German procedure differs from US class action suits in that, under the German system, the court pronounces an individual decision for each claimant. In contrast to the US, in Germany a claimant cannot opt out of test case proceedings.

Remuneration disclosure

Under the new **Board Remuneration Disclosure Act** (*Gesetz über die Offenlegung der Vorstandsvergütungen*) (**VorstOG**) there is for the first time a duty in Germany to publish the remuneration paid to the individual directors of listed companies. Formerly, companies were only required to disclose the aggregate remuneration paid to all directors, although the German Corporate Governance Code recommended voluntary disclosure of individual directors' salaries.

The revised law requires listed companies to state, against the name of each director, the entire remuneration paid to him. The amount must be broken down into fixed and performance-related components and components that provide a long-term incentive, such as stock options. The individual benefits promised to the director should he leave the company - in particular, pension and settlement payments, which in practice form a substantial component of board remuneration – must also be disclosed. The VorstOG does not go as far as the UK Directors' Remuneration Report Regulations, however: for example, there is no requirement to put the directors' remuneration to an advisory vote.

The shareholders can opt out of the VorstOG by a majority of three-quarters of the share capital represented in the vote. If so, the previous provisions apply, and the aggregate remuneration paid to the entire board of directors must be published in the annual financial statement.

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