

LEGAL ALERT

CORPORATE & COMMERCIAL NEWSLETTER

Rollits
SOLICITORS

CORPORATE

PRE-EMPTION PROVISIONS - VALUATIONS

Articles of association and shareholders' agreements for private companies can often contain provisions dealing with share transfers which require any shareholder who wants to sell his shares to first offer them to other shareholders at a price to be agreed between the shareholders or, if they cannot agree, at a price to be determined by the company's auditors or an independent accountant. These are commonly referred to as pre-emption provisions.

Auditors (as opposed to independent accountants) are often chosen to determine the price for the shares because of their familiarity with the company, which can often mean the valuation can be carried out relatively quickly and cheaply.

New ethical standards implemented by the accounting profession may prohibit auditors from carrying out valuation services for audit clients where the valuation would involve a significant degree of subjective judgement and have a material effect on the company's financial statements. There are exemptions for small unlisted companies which satisfy certain requirements. For companies which do not fall within this exemption, auditors may now decline to provide valuations on the operation of pre-emption provisions.

If the auditors decide they cannot do the valuation and the pre-emption provisions do not specify an alternative procedure, this can lead to difficulties. The easiest solution would be for the shareholders to agree to an independent accountant carrying out the valuation. However this can be difficult to achieve if the shareholders are unwilling to co-operate or if their number makes this impracticable. In such a situation, a shareholder who wishes to sell may be forced to apply to the Court for assistance.

However, where the pre-emption provisions specify the valuation will be done by a named person or someone, such as an auditor, with special knowledge relevant to the valuation, the Court may be unwilling to order independent accountants to do the valuation on the basis that the requirement for the auditors to do the valuation was such an essential part of the pre-emption provisions.

An easy way around this is for the shareholders to amend the articles of association and/or shareholders' agreement to provide for an independent accountant to carry out the valuation, where auditors decline to do it.

Shareholders should carefully consider whether any articles of association and/or shareholders' agreement require amendments. If so, they should act now to put the necessary changes in place; while it might be hoped that shareholders could agree to co-operate and resolve the matter in a simple and straightforward way if this issue arose in the future, this cannot be relied on, particularly as shareholders can often be in dispute when pre-emption provisions are being used.

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CHARGES OVER BOOK DEBTS - FIXED OR FLOATING?

For some time the law surrounding whether or not it is possible to grant a valid fixed charge over book debts has been very unclear. Over the last twenty five years case law has offered different views, but the latest decision of the House of Lords in *Re Spectrum Plus Limited (In Liquidation)* has hopefully put an end to the debate.

There has been little or no doubt that the judiciary's approach to the concept of a fixed charge over book debts has changed in the last twenty years.

You may ask what all the fuss is about. Well, there are some key differences between fixed and floating charges. Fixed charges rank in priority to unsecured claims and floating charge holders. And since the enactment of the Enterprise Act in 2003, a proportion of the company's assets are now (in respect of charges created after 15 September 2003) to be made available to the unsecured creditors in preference to the floating charge holders, subject to certain limits. Lenders generally prefer to take fixed charges as they give greater certainty and better security for a lender, which is one of the reasons why this decision is so important.

To cut a very long series of judgments and a long history of case law short, the House of Lords held that the terms of the charge must be construed strictly to see whether or not a fixed charge can be granted. What the charge is called, the label, is irrelevant. A decisive factor is the ability of the lender (or the person granting the charge, known as the 'chargor') to deal with the assets being

charged. If there are no restrictions on the chargor's ability to use book debts and their proceeds, the charge will be floating and not fixed. It is an essential characteristic of a fixed charge that assets can be released from the security only with the "active concurrence" of the lender. As the total amount of book debts owing can change all the time and providing the chargor cannot collect them, spend them, or in any other way deal with them without the consent of the lender (usually a bank), then it can be possible to create a fixed charge over them. But the terms of the charge must clearly give the lender the sole right to deal with them and, in particular, there must be clear restrictions on the control of the account into which the proceeds of the book debts are paid.

Where the lender has no 'control' over the assets charged it will only be possible to create a floating charge over them. The Spectrum decision is important and it has done a lot to clarify an area of law which has been unclear for many years. Lenders taking (or who have taken) security over book debts will need to consider the nature and effect of their security carefully to ensure that they do not fall foul of the latest decision of their Lordships.



EMPLOYER'S DEBT ON LEAVING A SCHEME

Until recently, where an employer left a group final salary (defined benefit) scheme that was in deficit, a debt became due in respect of that employer which was equal to its share of any deficit in the scheme at that time, and was calculated on a minimum funding requirement (MFR) basis (which has been the prescribed basis for valuation of final salary schemes, where the scheme's assets are measured against its liabilities under specified actuarial assumptions).

Recent regulations now provide for calculating the debt on a full buyout basis i.e. the full cost of buying annuity policies to secure all members' benefits, and which generally would result in a much higher deficit than the MFR basis. These provisions apply from 2 September 2005, and provide that the debt is payable in full on exit.

The regulations allow a "withdrawal arrangement" to be entered into involving the trustees of the scheme and the exiting employer instead of the exiting employer paying the full buyout cost of its debt.

The exiting employer must notify the Pensions Regulator that it intends to implement a withdrawal arrangement, which must provide for an immediate amount to be paid to the scheme by the exiting employer calculated on the lower MFR basis (although it is expected that this may be switched to a new scheme specific funding basis (see "Pensions - Scheme Specific Funding" article) in the near future).

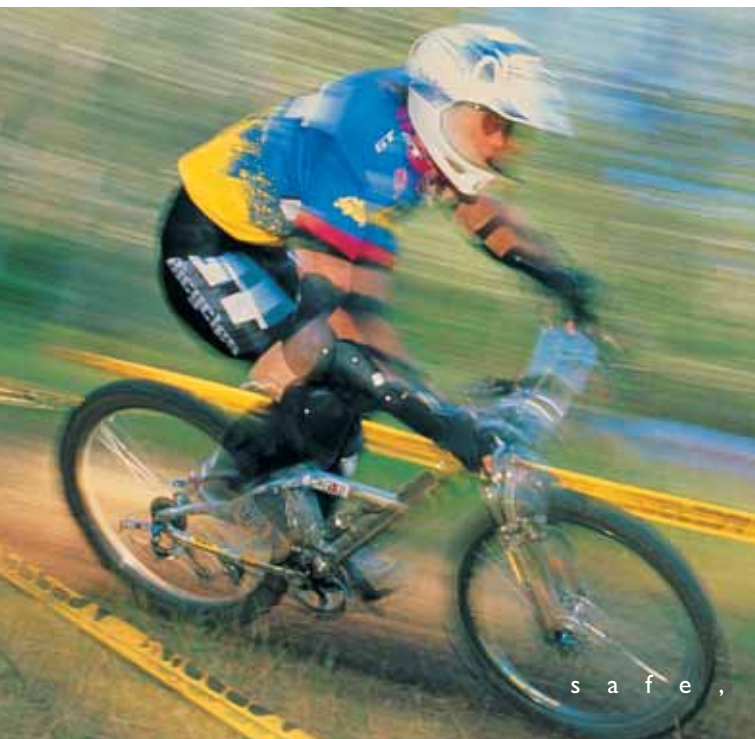
The withdrawal arrangement must also normally provide that the difference between the debt calculated on the full buyout basis and the amount paid by the exiting employer on the MFR basis becomes payable by a guarantor on the occurrence of specified future events. A guarantor is likely to be another group company participating in the scheme, but could also be a buyer of the exiting company.

Once the exiting employer makes its payment its liability to pay any deficit is discharged, even if the guarantor does not pay the balance.

A withdrawal arrangement can allow corporate transactions to occur without the exiting company becoming liable for significant sums to be paid into the scheme, although it can also cause group companies to become locked into long-term guarantee arrangements (which can remain in force until the winding-up of the scheme).

There may be scope for putting a withdrawal arrangement in place in advance of a proposed corporate transaction, which would fall away if the transaction does not complete.

Thought will need to be given at an early stage as to how potential deficits are to be treated, and to consider discussing possible withdrawal arrangements with the trustees of the scheme. Negotiations with potential buyers on who bears the financial burden of paying the deficit and adjusting purchase price mechanisms must also be considered.



JULIAN WILD JOINS ROLLITS AS FOOD GROUP DIRECTOR



Julian Wild

Julian Wild has recently joined us as Food Group Director. Julian was previously a senior executive for over 25 years at Northern Foods plc. Julian's principal role is to head a new Food Group within the firm. As Food Group Director, Julian will use his extensive knowledge of the food sector to lead a legal team specialising in food law and mergers & acquisitions in the food sector. During his career at Northern Foods Julian was one of the leading M&A professionals in the UK food industry.

It is unique among UK law firms to have a specialist food team headed by someone with Julian's industry experience. With this appointment, and the development of a new Food Group, we will provide a comprehensive service to food companies across the country.

We now have the benefit of Julian as Food Group Director working within the food M&A sector, as well as Neil Jenneson as Director of Corporate Finance. This will give us the capability to broker deals from their inception, provide corporate finance advice on deals and provide legal advice to see the transaction through to conclusion. This is a capability that is extremely unusual in a UK law firm and very valuable to our clients. It also emphasises our involvement in transactions from their inception to conclusion, which provides increased efficiencies for our clients.

The Corporate and Commercial department has extensive experience of advising food companies across a wide range of activities, which include advising

- Cranswick plc for over 20 years on its flotation, subsequent share issues and numerous acquisitions. These include its £80.6m acquisition of Perkins Chilled Foods earlier this year (which also included advice on its new banking facilities and the stock exchange formalities involved on the issue of a class 1 circular to shareholders and cash placing). The Cranswick group is an award winning food supplier whose range includes pork, bacon, ham, sausages, charcurie and sandwiches. In addition the group supplies a range of products to the pet and aquatic sector.
- William Jackson & Son group for over 13 years, including advising on the sale of Jackson Stores to J Sainsbury plc last year.

SHARE OPTIONS

EMI OPTIONS ON SALE OF COMPANY

EMI (enterprise management incentives) options can prove to be a tax efficient way to recruit, retain or incentivise employees.

The exercise price for EMI options can be less than market value at the time of grant, although the most favourable tax treatment will be received if the options are granted at market value. In contrast to other tax-favoured schemes, EMI options do not require approval of HM Revenue & Customs, although the grant of options must be notified to the Revenue and other qualifying conditions must be met.

As no Revenue approval is required, it is possible for the terms of the options to be tailored to a company's individual desires. For example, the option terms may only allow exercise on the sale of a company and can require that the shares acquired must be sold to the buyer (so as to prevent the optionholders blocking the sale). If options are only exercisable on a sale this also means employees will not be shareholders until immediately before a sale and so avoid any "nuisance" factors that can sometimes prevent a company introducing a share scheme for employees.

Depending on the precise circumstances, it is even possible for EMI options to be used in anticipation of a sale to provide a tax efficient method of sharing value amongst employees. In such a case, however, there should not be arrangements in place relating to any proposed sale. For example, if there has been any approach from, or to, a prospective buyer, or if heads of agreement have been agreed, EMI status is likely to be denied.

No income tax or national insurance is payable by the employee on the grant or exercise of the options so long as the options are granted at market value, nor is there a national insurance charge on the employer. Capital gains tax is payable on the sale of the shares but this can be mitigated by employees using their CGT annual exemption and/or relying on taper relief which can effectively reduce the rate of CGT to 10% if options have been held for at least two years from the time of grant. In addition, the company should receive corporation tax relief on exercise of the options based on the difference between the market value of the shares at the date of exercise and the exercise price. This relief increases the value of the company and so should be taken into account in price negotiations if the EMI options are to be exercised on a sale.

An employee can hold EMI options over shares worth up to £100,000 valued at the respective times of grant so the potential tax savings can be substantial.

HOW TO AVOID EARN OUT BURN OUT

Shareholders who are looking to sell out are often frustrated that their preferred buyer does not value their shares as highly as they do! Buyers are understandably cautious in factoring into the price a large figure for goodwill. A possible compromise is for the price for the shares to consist of a certain amount payable on completion and a possible further amount or amounts payable in the future based upon the profits made by the company in the year(s) after it has been taken over. The latter element is commonly referred to as an "earn out".

Earn outs throw up capital gains tax ("CGT") issues and it is possible for the sellers to end up paying more tax than was necessary if the earn out is not properly structured.

The right to receive the earn out is treated as an asset for CGT. This leads to the following unwanted complications (unless the earn out right is structured as detailed later):

- The sellers will pay CGT on the initial consideration plus whatever is the value of the earn out right (even though at that stage they would not have received anything under the earn out right);
- Valuing the earn out right is tricky (to say the least);
- When the sellers receive further amounts pursuant to the earn out right this will be treated for CGT as a disposal of the earn out right itself (not the shares that were sold); and
- The earn out right is not a "business asset" and so there will not be much (if any) taper relief available against any sums received by the sellers under it. This would come as an unwelcome surprise to a seller who was expecting full taper relief and an effective 10% CGT rate on all the consideration received for his shares.

These complications can be avoided if the amount to be received under the earn out right is payable in shares or loan notes issued by the buyer. In that case the earn out right will be treated as a "security" for CGT purposes that was acquired at the same time as the shares in the company that were sold.



This has the following happy consequences:

- The value of the earn out right will not be chargeable to CGT on completion;
- There will not be a CGT charge when the shares or loan notes are received under the earn out right. Indeed, there will not be a charge to CGT relating to the earn out until the shares or loan notes issued by the buyer are sold or redeemed; and
- The earn out right is likely to be treated as a "business asset" for taper relief purposes and the period of ownership for calculating taper relief will stretch back to when the shares in the company were acquired by the sellers. This means maximum taper relief might still be achieved.

This favourable treatment is not available where cash is, or could be, paid directly to the sellers under the earn out right. One solution is for the sellers to receive loan notes with a short redemption period: HMRC accept that a six month redemption period is adequate.

The favourable treatment is only given where the earn out right is for bona fide commercial purposes and not for the avoidance of tax. The sellers should apply for advance tax clearance for this.

CORPORATE

SHARE AND BUSINESS SALES - KNOWLEDGE OF BREACH OF WARRANTY

In our May Legal Alert we discussed the impact of the *Infiniteland* case on the legal position regarding a seller's liability for breach of warranty where a buyer had prior knowledge of the breach, which was not disclosed by the seller.

The *Infiniteland* case has now been appealed. The Court of Appeal did not have to consider whether there was a general rule of law preventing a buyer suing for breach of warranty where the buyer knew of the breach. However, the first decision of *Infiniteland* held there was no such rule.

Until this matter is finally resolved by the courts, whether a buyer can sue will probably depend on what the contract says:

- in the absence of any clause saying the buyer can or cannot sue for such a breach, the buyer probably can sue, although the courts may seek to penalise the buyer by awarding lower damages;
- if there is a clause which says the buyer cannot sue if it knew of the breach, the buyer will not be able to sue for that breach;
- if there is a clause which says the buyer can sue even if it knew of the breach, the courts will probably allow the buyer to sue but could again penalise the buyer by awarding lower damages

If the relevant clause refers to "actual knowledge" this will mean only the buyer's own knowledge. "Constructive knowledge" will cover things it should have known and "imputed knowledge" will include knowledge of the buyer's advisers, although the courts will only impute such knowledge in certain circumstances.

It is clear that buyers and sellers will continue to have conflicting views in seeking to agree the contractual position on corporate transactions.





COMMERCIAL

JOINT GOODWILL

The case of **Robert McAlpine v Alfred McAlpine** is the first to rule on a claim in passing-off by one joint owner of goodwill against the other joint owner. The businesses of Robert McAlpine ("RM") and Alfred McAlpine ("AM") had coexisted since the original business owned by Sir Robert McAlpine was split between his sons.

The case arose because the business of AM decided to re-brand itself as "McAlpine". It did not notify RM in advance and RM only became aware of the name change on the day of the press launch.

RM was able to show that it was frequently referred to as "McAlpine" and so for AM to change its name to "McAlpine" was a misrepresentation that it was in fact RM. The Judge agreed with this argument.

In order to succeed in its action for passing off, RM also had to show that there was damage to its goodwill as well as the misrepresentation. RM did not allege that the re-branding would lead to a direct loss of business. This was probably because most customers of the two companies were professional customers and knew that they were separate businesses with similar names. RM argued that any negative publicity which may occur in the future to AM could affect RM and that this was a proper head of damage that could be suffered by RM.

The Judge agreed with RM's submission and found that where goodwill in a name is held by joint owners neither of them is entitled to appropriate that name in a manner which is detrimental to the other party's interest in the same name. He found that the identifiers "Robert" and "Alfred" served to limit the risks of sharing a name and for one of the businesses to remove that identifier was inevitably to cause damage to the other business.

The Judge said that he did not consider himself to be inventing a new tort of "misappropriation of goodwill" but his judgment does come close.

DEAL WATCH

Since our May Legal Alert, transactions we have acted on include the following:

Amber Travel Partnership



Amber Travel Partnership - sale to a company established by Primary Capital, a private equity house based in London.

The Rollits team was led by Richard Field (Corporate) and included Tom Farrington and Craig Engelman (Corporate), Nasim Sharf (Tax) and Carol Bailey (Commercial Property).

The Amber Travel Partnership (which includes Intravel Limited, Great Rail Journeys Limited and Filoxenia Limited) is a group of specialist, independent travel companies offering a wide range of holiday ideas to discerning travellers. Intravel recently won three awards at the Guardian & Observer Travel Awards as Best Ski Company, Best Short Breaks Company and Best Tour Operator Website. It was also named 4th overall in the Best Tour Operator category.

PENSIONS

SCHEME SPECIFIC FUNDING

The minimum funding requirement (MFR) originally introduced in the Pensions Act 1995 (which has been the prescribed basis for valuation of final salary (defined benefit) schemes, where the scheme's assets are measured against its liabilities under specified actuarial assumptions) is scheduled to be replaced at the end of December by the statutory funding objective. This seeks to require all final salary schemes to have sufficient assets to cover their "technical provisions" - i.e. the amount required to cover the scheme's liabilities. Such liabilities are to be calculated in accordance with a framework of methods and assumptions that are due to be provided in regulations due to be published in December.

Trustees will be required (with actuarial input) to produce a statement of funding principles setting out how the statutory funding objective is to be achieved for their specific scheme (hence 'scheme specific funding'), which should be agreed with the employer, failing which the trustees will be able (with employer consent) to modify future benefit accrual.

Actuarial valuations will still be required every three years, with annual updates from the actuary on any factors affecting the value of the liabilities since the previous valuation. The trustees will then need to agree a schedule of contributions with the employer, and a recovery plan for making up any shortfall in the statutory funding objective.

These new rules will apply to valuations based on an effective date of 22 September 2005 onwards but completed after 30 December 2005. Schemes starting a valuation between 22 September and 30 December will be allowed a further three months, in addition to the total of fifteen months generally allowed, to complete their first valuation under their new requirements and put an updated schedule of contributions in place.



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EMPLOYMENT

CHANGES TO TUPE REGULATIONS

Long awaited changes to TUPE will now come into force in April 2006. All those involved in business sales and service provision will know the difficulties and uncertainties created by these Regulations which have as their aim the protection of employees and achieve this by transferring all employee liabilities to any purchaser or incoming contractor.

In many circumstances no one has been able to be certain whether or not TUPE applies. This has made it difficult for contractors tendering for the provision of services including cleaning, security, catering and maintenance. The problems are exacerbated by a lack of goodwill and co-operation from any outgoing contractor and by a client whose main aim is to do and say nothing.

Under "New TUPE" any change of service provider will be caught where there is an ongoing activity and an organised grouping of employees carrying it out. Although this widens the scope of TUPE, most contractors will be grateful for the increased certainty.

Further, there will be a new obligation on any outgoing contractor to provide details to the new contractor of the employees and the terms and conditions he will be inheriting.

Disappointingly, there will still be only very limited scope for the acquirer of a business or contract to vary terms and conditions, even if the employees agree. To be valid any variation will have to be linked to a change in the composition or job functions of the workers. That will not include a simple desire to harmonise terms. There will be greater flexibility under "New TUPE" in insolvency situations where the aim is to ensure the survival of the business.



COMMERCIAL

ALIENS, MEATBALLS AND HMS INVINCIBLE

The Freedom of Information Act 2000 came fully into force on 1 January 2005. Since then anyone who requests information from a public authority has to be told whether the authority holds the information and (unless one of the Act's exemptions applies) be supplied with that information.

The Act lists public authorities, which are covered by the regime, including Government departments, local authorities and the armed forces. In the past eight months the Ministry of Defence has received 3,000 requests for information under the Act. Amongst the more interesting requests are:

- How many alien sightings have there been in the past two years?
- What is the old Royal Navy recipe for Curried Meatballs with Sauteed Kidneys?
- What are the decommissioning plans for HMS Invincible?

The MoD's responses to these and other information requests can be read online at www.mod.uk/publications/foi/rr/index.htm. Whilst some of the requests make for amusing reading, the Act raises important issues for businesses. Businesses supplying goods or services to public authorities provide them with information, which may become disclosable to enquirers - even where the enquirer is a competitor of the business!

The Act contains several exemptions from disclosure. The most relevant for businesses dealing with public authorities are that information is exempt from disclosure if (i) disclosing it would amount to an actionable breach of confidence or (ii) the information consists of a trade secret, disclosure of which would prejudice the business' commercial interests. The authority would also have to consider whether the public interest in maintaining the exemption outweighs the public interest in disclosing the information.

Businesses should review the information they provide to public authorities and ask to be part of the disclosure process if a relevant information request is received. Ideally businesses should incorporate confidentiality obligations in their public authority contracts, although there is Governmental pressure on authorities not to accept them.

We have acted for several clients where we have successfully shown that the above exemptions apply, but ultimately the public authority has exclusive jurisdiction to decide whether to release information to an enquirer. If a business does not agree with the authority's decision it will have to appeal to the Information Tribunal to try to reverse the decision.

INFORMATION

If you have any queries on any articles in this newsletter or other corporate or commercial matters generally please contact:

Richard Field or Tom Farrington on (01482) 323239

This newsletter is for the use of clients and will be supplied to others on request. It is for general guidance only. It provides useful information in a concise form. Action should not be taken without obtaining specific advice.

We hope you have found this newsletter useful. If, however, you do not wish to receive further mailings from us, please write to Mrs. Pat Coyle, Rollits, Wilberforce Court, High Street, Hull, HU1 1YJ.

**The law is stated as at 24 October 2005
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