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Insights

CORPORATE BRIEFING - AUGUST 2023

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SUMMARY

Welcome to the Corporate Briefing, where we review the latest developments in UK corporate law that you need to know about. In this month's issue, we discuss:

Prospectus reforms

- Following a fundamental review of the prospectus regime, draft legislation has been published aimed at making the regime more flexible and responsive to changing market conditions.

Investment Research Review

- The government has accepted all the recommendations in the Investment Research Review including changing the rules, introduced in 2018, designed to encourage unconnected research analysts to produce research in connection with IPOs.

Digitisation Taskforce – interim report

- An interim report has been published recommending, amongst other things, that legislation is introduced, as soon as possible, to stop new paper share certificates being issued and to require dematerialisation of all share certificates in the future.

EU Foreign Subsidies Regulation in force

- The EU's FSR took effect on 12 July 2023 introducing mandatory notification requirements for certain deals and public procurements.

FRC insight report on dividends

- The FRC has published a report with their insights on current market practices and the factors that are changing the context in which investors assess dividend policy.

IA guidance on effective requisitioning of shareholder resolutions

- The Investment Association has published useful guidance on requisitioning shareholder resolutions in the UK.

Revised CGI code of practice and guidance notes on board performance

- The Chartered Governance Institute has released updated versions of documents aimed at promoting transparency and accountability in board performance reviews.

Lessons to learn from a disputed W&I claim

- A recent case highlights lessons to learn in relation to the meaning of material adverse change, warranty drafting, buyer's knowledge provisions, and over-reliance on W&I.

PROSPECTUS REFORMS

Lord Hill's Review, in 2020, recommended that the government undertake a fundamental review of the UK prospectus regime to make it more flexible and responsive to changing market conditions. As a result and after several consultations, draft legislation has now been published with the expectation that final legislation will be enacted by the end of 2023, subject to parliamentary time allowing. Key changes include:

- **a new public offer regime**– all public offers of relevant securities will be prohibited unless the offer falls within one of the exemptions (as opposed to the current regime where public offers require a prospectus unless an exemption applies);
- **admission to trading on regulated markets**– the FCA will have enhanced rule-making responsibilities to specify when a prospectus is required and what it should contain;
- **admission to trading on multilateral trading facilities ("MTFs" ie. AIM)**– the FCA will have rulemaking powers over 'primary MTFs' and may require an issuer to publish a document referred to as a 'MTF admission prospectus' as a condition of admission of the securities to trading on AIM. This document will not need to be reviewed or approved by the FCA and the London Stock Exchange will retain broad discretion over the content requirements but it will be subject to withdrawal rights, the responsibility provisions for prospectuses and the provisions detailed below on forward-looking statements;
- **forward-looking statements**– there will be a different liability threshold, based on fraud or recklessness (as opposed to negligence), for certain categories of forward-looking statements in prospectuses or MTF admission prospectuses with the aim of encouraging issuers to include statements that predict the future performance of a company and which are useful to investors when deciding whether to acquire securities; and

- **offers of securities not admitted to trading**– offers of securities above a £5 million threshold will need to be made through a public offer platform or within the scope of one of the other exemptions from the prohibition on offers to the public. The existing exemption for offers below €8 million will be removed.

Whilst a large part of the existing regime will change, some principles and aspects will be retained including the 'necessary information test' to ensure that an overall standard of preparation remains. Comments on the draft SI are requested by 21 August.

INVESTMENT RESEARCH REVIEW

The government has welcomed the UK Investment Research Review. There is a consensus that investment research is an important part of the UK public capital markets and the availability and quality of expert analyst research is significant in attracting (and retaining) issuers and investors. The Review identified seven recommendations for action aimed at protecting and developing the UK as a centre of excellence for investment research.

Recommendations:

1. Introduce a Research Platform to help generate research. Improved research coverage would help promote a greater interest in smaller cap companies where there is currently a paucity of research coverage; it could also be used to initiate research on private companies and to provide accessibility of investment research to retail investors.

2. Allow additional optionality for paying for investment research. To address some of the consequences of the MiFID II unbundling requirements, the Review recommends additional optionality regarding payment for research to permit asset managers to pay for research on a bundled basis and to ensure that UK asset managers remain able to procure research from elsewhere, particularly from the US.

3. Allow greater access to investment research for retail investors.

4. Involve academic institutions in supporting investment research initiatives. The Research Platform should explore a range of mechanisms to strengthen the collaboration between academic institutions and the capital markets ecosystem on the basis that the UK has leading expertise in the world of academia.

5. Support issuer-sponsored research by implementing a code of conduct.

6. Clarify aspects of the UK regulatory regime for investment research and consider introducing a bespoke regime. This could involve simplifying the current regime or introducing a bespoke regime relating specifically to investment research.

7. Review the rules relating to investment research in the context of IPOs. The Review recommends that the following points are considered further:
   - changing the FCA Conduct of Business Rules, introduced in 2018, designed to encourage unconnected research analysts to produce research in connection with IPOs. These rules have not had the desired effect of increasing IPO coverage by unconnected analysts but have consequentially extended the UK IPO timetable, putting the UK at a competitive disadvantage;
   - making IPO connected analyst research available on a basis similar to the prospectus so that all investors can access the same information; and
   - the current restrictions on connected analysts meeting potential IPO candidates prior to an investment bank being mandated on the IPO are also seen as putting the UK at a disadvantage to other listing venues.

The government has accepted all of the recommendations in the Review and welcome the FCA's commitment to start immediate engagement with the market to introduce these reforms. The anticipated timetable for these is by the first half of next year.

DIGITISATION TASKFORCE – INTERIM REPORT

In July 2022 a Digitisation Taskforce ("Taskforce") was established "to drive forward full digitisation of the UK's current shareholding framework". Following engagement with stakeholders, the Taskforce has published an interim report with potential recommendations for the government and asking for feedback. There was overwhelming support from issuers to remove paper share certificates as a matter of urgency with some differences of opinion on whether a progressive approach should be adopted or a 'big bang'.

Potential recommendations:

- Legislation should be brought forward as soon as practicable to stop the issuance of new paper share certificates.
- The government should bring forward legislation to require dematerialisation of all share certificates.
- The government should consult with issuer and investor representatives on the preferred approach to 'residual' paper share interests and whether a time limit should be imposed for the identification of untraced Ultimate Beneficial Owners ("UBOs").
- Intermediaries should have an obligation, as a condition of participation in the clearing and settlement system, to put in place common technology that enables them to respond to UBO requests from issuers in a very short timeframe.

- Intermediaries offering shareholder services should be fully transparent about whether and the extent to which clients can access their rights as shareholders including charges.
- Where intermediaries offer access to shareholder rights, the baseline service should facilitate the ability to vote, with confirmation that the vote has been recorded, and provide an efficient and reliable two-way communication and messaging channel, through intermediaries, between the issuer and the UBOs.
- Following digitisation of certificated shareholdings the industry should move, with legislative support, to discontinue cheque payments and mandate direct payment to the UBO's nominated bank account.

A final report is due to be published within six months.

EU FOREIGN SUBSIDIES REGULATION COMES INTO FORCE

The EU's Foreign Subsidies Regulation ("FSR") took effect on 12 July 2023 introducing mandatory notification requirements for certain deals and public procurements falling within certain thresholds. The European Commission has been granted substantial authority to impose fines and enforce remedial measures for non-compliance. Starting from 1 October 2023, the mandatory notification regimes will be operational with the following thresholds:

M&A THRESHOLD

a. The target, one of the merging parties or the joint venture has EUR 500 million EU turnover; and

b. The parties received aggregate foreign financial contributions exceeding EUR 50 million in the last three years.

PUBLIC PROCUREMENT THRESHOLD

a. Contract value is at least EUR 250 million or aggregate value of lots is at least EUR 125 million; and

b. Bidding party and its main subcontractors have received foreign financial contributions of at least EUR 4 million in the last three years.

Deals captured by the M&A threshold for which agreements are concluded or public bids announced on/after 12 July 2023 must be notified to the Commission unless they complete before 12 October 2023. The same applies for public procurement contracts meeting the procurement threshold where procedures are initiated on/after 12 July 2023.

Read our insight, "The EU's foreign subsidies regulation goes live as the European Commission finalises the notification requirements for businesses".

FRC INSIGHT REPORT ON DIVIDENDS

The FRC's insight report of current market practices has identified three factors that are changing the context in which investors assess a dividend policy:

- **Macro** - how does the policy reflect macro factors such as economic slowdown, inflation and interest rate environment, etc. An example provided is where a company has adjusted its dividend policy to grow the dividend per share in line with the increase in average UK CPIH inflation each year. In addition, the company disclosed the amount of distributable reserves available, confirming that it is sufficient to cover more than five years of forecast group dividends. This aligns with the Government proposals, in its White Paper on 'Restoring Trust in Audit and Corporate Governance', for in-scope companies (or the parent company in the case of a group) to disclose their distributable reserves;

- **Market** - how does the policy reflect market factors such as peer comparison, the need to respond to industry trends, etc. In this context, one company linked its dividend decision to several factors crucial to firms operating in the sector: successful mitigation of operating cost inflation, the interests of wider stakeholders, and a strong cash flow; and

- **Entity** - how does the policy reflect company factors such as the need to invest in green transition, financing and debt repayments, staff and customer support, etc. The company identified linked its thinking around dividends to the strengths of its business model and in particular the company clearly acknowledged that adverse effects relating to its defined benefit pension scheme could interact with its ability to pay dividends in the future.

The FRC concludes that although many companies have promised a progressive dividend policy, investors and other stakeholders also expect better, more focused disclosure which reflects and adjusts to the changing environment.

IA GUIDANCE ON EFFECTIVE REQUISITIONING OF SHAREHOLDER RESOLUTIONS

The Investment Association ("IA") has released guidance on the effective requisitioning of shareholder resolutions in the UK, encouraging institutional investors to consider this escalation tool when standard engagement processes fail to bring about desired changes in company behaviour. The guidance outlines key steps required to effectively file a resolution and advises investors to undertake the following preliminary steps to assess the feasibility of successfully filing the resolution:

- establish if other institutional investors are willing to support efforts to requisition a resolution;

- conduct internal governance and gain approvals from internal stakeholders; and

- engage with non-institutional investor external stakeholders e.g. proxy advisers and the media to gather support and increase pressure on the company to address the issues being raised in the resolution.

The guidance also sets out the legal requirements for requisitioning a resolution, submission deadlines, accessing shareholdings (through the intermediated security chain) and drafting tips for the resolution and supporting statement. The IA guidance notes that goal-based resolutions which allow company management to propose its own strategy to achieve the specified goal have a greater chance of success rather than resolutions which appears to be dictating strategy.

REVISED CGI CODE OF PRACTICE AND GUIDANCE NOTES ON BOARD PERFORMANCE

The Chartered Governance Institute ("CGI") has released updated versions of documents aimed at promoting transparency and accountability in board performance reviews:

- The Code of Practice for board reviewers establishes clear eligibility criteria, principles, and recommendations for third-party reviewers, emphasising the importance of transparency, client disclosure, and a robust process for addressing concerns.
- The Principles of Good Practice for listed companies highlights the importance of avoiding conflicts of interests by appointing a reviewer through the nomination committee and ratifying the decision by the full board, where appropriate. The guidelines recommend clear terms of engagement, direct access to the board and stakeholders, and opportunities for the reviewer to present their findings.
- The reporting on board performance reviews provides guidelines for reporting on board evaluations in the annual report. Annual reports should address how the evaluation was conducted, the actions that have been taken, how it has influenced board composition and provide external reviewers the chance to comment on the findings presented in the report.

LESSONS TO LEARN FROM A DISPUTED W&I CLAIM

Finsbury Food Group Plc v Axis Corporate Capital UK Ltd [2023] EWHC 1559

The claimant in this case was a listed company buyer of a family-owned bakery business. It bought the business to establish a position in the gluten free market and help build its brand – but the deal was received cautiously by the City and there was a concern that the buyer had overpaid. This led to a focus on earnings – and when they didn't improve, attention turned to possible breaches of the warranties in the share purchase agreement ("SPA") – which might in turn give the buyer a claim under the warranty and indemnity ("W&I") insurance policy it had taken out.

The buyer claimed that price reductions agreed with the business' main customer before completion amounted to a breach the following two warranties:

Since the Accounts Date:

- there has been no material adverse change in the trading position of any of the Group Companies or their financial position, prospects or turnover and no Group Company has had its business, profitability or prospects adversely affected by the loss of any customer representing more than 20% of the total sales of the Group Companies or by any factor not affecting similar businesses to a like extent… (the "Trading Conditions Warranty"); and…
- no Group Company has offered or agreed to offer ongoing price reductions or discounts or allowances on sales of goods relating to its business or any such reductions, discounts or allowances that would result in an aggregate reduction in turnover of more than £100,000 or would otherwise be reasonably expected to materially effect [sic] the relevant Group Company's profitability (the "Price Reductions Warranty").

The buyer claimed against the insurer – but the insurer disputed the claim and the court found in its favour. The lessons to be learnt are as follows:

SPECIFY WHAT YOU WANT 'MATERIAL ADVERSE CHANGE' TO MEAN

"Material adverse change" has no set meaning in law. What it means is fact specific and therefore uncertain. In this case the judge determined that the "20% of total sales" test specified in the warranty only applied to the later part of it and that a material adverse change that exceeded 10% of sales would be a breach of the first part. However, this should not be assumed to be the test that will apply generally (and in another recent case the judge determined that a change was material if it would cause a reasonable person – with the aims and objectives of the buyer – to withdraw from the transaction or renegotiate its terms). The best approach – for certainty - is to specify what counts as a material adverse change (and, acting for buyer, to do this by way of example, rather than exhaustively).

REMEMBER THAT THE SCOPE OF A WARRANTY MAY BE LIMITED BY THE OTHER WARRANTIES

The judge determined that the price reduction claim could arguably have been made under the Trading Conditions Warranty – were it not for the fact that there was the separate Price Reductions Warranty. He considered that the parties had treated price reductions separately and set out specific and separate criteria for them. It is not uncommon for the courts to take this approach. If they see that the parties have turned their minds to an issue in one place, they will not readily allow a more general provision to extend the rights and obligations of the parties in relation to that issue. So, in this case, the buyer had no right of action under the Trading Conditions Warranty in respect of the price reductions.

DRAFT WARRANTIES VERY CAREFULLY

The purpose of the Price Reductions Warranty was presumably to flush out any price reductions taking effect after the Accounts Date - so that a true comparison could be made with the previous period. But the warranty didn't refer to reductions *taking effect* after the Accounts Date but to reductions *offered or agreed* since the Accounts Date – and as the reductions had been agreed before the Accounts Date there was no breach of the Price Reductions Warranty (even though they only took effect after the Accounts Date).

CONSIDER THE EFFECT OF BUYER'S KNOWLEDGE

As the judge found that there had been no breach of warranty, the issue of the buyer's knowledge wasn't strictly relevant. But he determined that the buyer had no claim in any event because of a buyer's knowledge provision in the SPA and the W&I policy. The provision in the SPA provided that there would be no liability under a warranty claim to the extent that the buyer (as at the date of the SPA) had "(i) actual knowledge of the circumstances of such Warranty Claim and (ii) is actually aware that such circumstances would be reasonably likely to give rise to a Warranty Claim." And for the purposes of that provision, the knowledge of the buyer was limited to such facts, matters or circumstances as were in the actual knowledge of three named individuals. As regards one of those individuals the judge determined that: he was aware of the price reductions (though he denied that); and that he was aware of the terms of the SPA (though he denied that too). However, the judge determined that he did not have express awareness that the information he had was likely to give rise to a warranty claim – because he had not given that any particular thought at the time – but that he would, or at least should, have concluded that if he had considered it. On that basis, the judge decided that the knowledge exception applied – as the individual in question 'had sufficient information available to him' (and that his evidence had been untruthful because he recognised that his knowledge was fatal to the buyer's case). The insurer's submission was that it was sufficient to provide the data 2 + 2 – and the judge seems to have agreed that it was the obligation of the recipient of that data to 'do the maths'. But parties will want to make the position clear in the drafting of their knowledge provisions.

DON'T ASSUME THAT W&I COVER IS A PANACEA

The family sellers had mixed feelings about selling and in order to smooth the process the buyer promised a light touch due diligence exercise, scaled back the warranties, and took out a W&I policy to cover claims that may arise under the SPA. But – as can be seen from the above - a W&I policy is not a cure-all and does not obviate the need for thorough due diligence and robust warranties.

HAVE A ROBUST VALUATION METHOD

The price demanded by the sellers was £20 million - justified on the basis of 1 x current sales, rather than being based (as would usually be the case for a business like this) on a multiple of earnings -

and the buyer proceeded on that basis. But when the buyer made its claim under the W&I policy it sought to do so applying an earnings based valuation. It notified the W&I insurer that it's claim was likely to exceed £4 million, calculating that amount by applying a multiple of 10 (the same multiple that, if applied to the earnings before the acquisition of c£2 million, would result in the £20 million price the buyer had in fact paid) to the c£400k reduction in earnings it claimed was a result of the price reductions. The court rejected this approach: if there had been a breach – and loss had been suffered – the judge stated that he would have calculated damages in the same way the price had been calculated – namely 1 x the impact on sales. But the judge went further and held that if there had been a breach, then the buyer hadn't suffered any loss as it would have proceeded with the deal at the £20 million purchase price anyway (as the sellers would not accept less). This is somewhat unusual, but a reminder that issues of causation and the calculation of damages – and how the rules are applied by the courts – are not straightforward.

RELATED PRACTICE AREAS

- Corporate

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