WHITE & CASE

June 2015

2015 Spring Review – M&A Legal and Market Developments

We set out below a number of interesting English and European court decisions and market developments which have taken place and their impact on M&A transactions. This Insight looks at these developments and gives practical guidance on their implications. Summaries feature below, and you can click where indicated to access more detailed analysis.

Contractual Provisions

A number of cases have looked at contractual provisions which are commonly seen on M&A deals

Warranty Notices and Attributing Fraud to Warrantor

The High Court has considered issues arising from a series of warranty claims against both buyer and seller on a transaction, including: when time started to run under a contractual obligation to notify a claim within a set period of becoming aware of the matter; the information required to meet an obligation to provide "reasonable detail" in the notice; quantification of damages on a warranty claim against the buyer in connection with a consideration share issue; and the circumstances when the fraud of the buyer's financial controller would be attributed to the buyer.

The sale and purchase agreement (SPA) said that the seller (S) would not be liable for a warranty claim unless the buyer (B) served notice of claim on S, specifying in reasonable detail the nature of the claim, within 20 business days "*after becoming aware of the matter*". B notified a claim against S for breach of S's management accounts warranties. S counterclaimed against B for breach of B's own accounts and management accounts warranties given in connection with a related consideration share issue. The court decided that the 20-day time period for notifying a claim did not start to run until B knew that a warranty claim had a proper basis. You needed a causal connection between knowing both a matter and that there was a proper basis for a claim. The court also said that the requirement to specify "reasonable detail" in the notice had been met and that "not much was contractually required"! This wording set a low bar, and to raise it a seller would need to use more prescriptive language. Separately on the counterclaim, the court also decided that B's breaches of accounts warranties had been caused by a fraud by B's financial controller (F) and it attributed F's fraud to B. This meant that the limitations in the SPA did not apply and B's liability was uncapped. Factors were: that F was a senior employee (albeit not a director) who had personally provided information of central importance for the deal to get done; that it was not a one-off instance in B's finance team of one person acting alone; and that senior management had allowed an atmosphere to develop which prompted the fraud. An appeal hearing is awaited in relation to the judgment. (*The Hut Group Limited v Nobahar Cookson and Another* [2014] EWHC 3842 (QB))

Key lessons

- **Level of knowledge for warranty notices and knowledge limitations:** Buyers should make sure that contractual requirements establish a causal link between knowing both a matter **and** that it gives rise to a claim.
- **Limiting attribution:** Warrantors should include express language to limit the people whose knowledge and behaviour may be attributed to them, although the judgment shows that this will not always be enough, and will not necessarily negate the effect of a wide, generic fraud carve-out.
- **Content requirements of warranty notices:** A well-placed seller could require more detail and impose fuller content requirements in the SPA.

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Contractual Provisions contd.

No Implied Duty on Buyer to Substantiate Claims before Escrow Release

The High Court has confirmed that, if there is no contractual obligation under an SPA for a buyer to provide details of claims or substantiate them before funds may be released from a retention/escrow, nor any contractual dispute resolution mechanism in relation to the retention/escrow structure, the court will not imply provisions along these lines. More generally, it will not imply terms just because the parties have used wording which appears biased in one party's favour.

S sold the entire shareholding in T, a company which ran a nursing home, to B. Around one-third of the purchase price was paid into a retention/escrow account held by B's solicitors as security for warranty and indemnity claims. Under the SPA B's solicitors had to pay the amount of any notified claims to B. B notified six claims and the solicitors paid out the full balance of the account to B. The court denied that there was an implied term as to accurately calculating and substantiating claims. The provisions of the SPA were clear and payments out of the retention/escrow did not need to be justified first to S nor require S's consent. The court will not improve the parties' agreement, but will apply unambiguous wording even if it appears unfavourable to one party. Instead the correct basis of claim by S was unjust enrichment, where the burden of proof was on S to show that B's claims were unfounded. A separate issue related to quantification of damages on a claim that T had missed the deadline for a necessary healthcare registration in breach of the standard warranty that it held all licences necessary for carrying on business. This had meant T was not on a register of approved healthcare suppliers over a period of time, missing out on customers. The court discussed quantification of damages where the warranty breach was an undisclosed fact (here, failing to meet the registration deadline). The court said that it could consider the likely implications of disclosure on parties' negotiations at the time when assessing the true value of the business, although it could not take into account information available since the date of the sale. The court also emphasised that the purpose of damages is not to reimburse financial loss, which is a function of indemnities. (*Bir Holdings Limited v Mehta* [2014] EWHC 3903 (Ch))

Key lessons

- **Substantiate claims:** Sellers should require claims to be substantiated before funds are released and consider joint release notices from the parties or even a QC's opinion.
- **Trigger events:** It is important to have clearly-defined trigger events for release of funds.
- **Dispute resolution:** A contractual dispute resolution mechanism involving an expert may help too.
- **Indemnity claims:** Indemnifiers could consider requiring written evidence to support indemnity claims.

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Who has Authority to Sign on behalf of Overseas Companies?

The Court of Appeal recently decided that an English law oil supply contract purportedly entered into between two Swiss companies was not binding because it had not been properly authorised or executed when it was signed by only one authorised signatory of the supplier, rather than two authorised signatories as required under Swiss law. The judgment underlines that the issue of who can bind the company is determined by English conflicts of laws rules, under which Swiss law applied as the law of the company's place of incorporation. The case highlights the importance of checking local law requirements to ensure that an English law agreement is validly executed.

Two Swiss companies purported to enter into a contract for the supply of oil products. The contract stated that it would be governed by English law and that the English court would have exclusive jurisdiction. The supplier made no deliveries and the customer brought proceedings for breach of contract. The supplier claimed that the contract was not binding because the joint signatures of two authorised representatives of the supplier were required to bind it under Swiss law. The Court of Appeal confirmed that, as a matter of English law, the question of who has authority to bind an overseas company to enter into an English law contract must be decided by the local law of that company's place of incorporation. It is not enough for an agreement to be executed by someone professing authority to sign for a company under local law – the agreement itself must comply with the relevant legal requirements. The customer has applied for leave to appeal. (*Integral Petroleum S.A. v SCU-Finanz AG* [2015] EWCA Civ 144)

Key lessons

- **Check local law requirements:** Check local law requirements to ensure that an English law agreement is validly executed.
- **Legal opinion or local advice:** Consider obtaining a legal opinion on due authority and execution or, in the least, local law advice on the required authorities and execution formalities.

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Contractual Provisions contd.

Factors Required to Establish Right to Terminate Outsourcing Agreement by Claiming Provider Ceased Material Part of its Business

The High Court recently considered the meaning of "material" in a contractual context, when a party would cease to carry on a material part of its business and, if it did, whether that had a material adverse effect (MAE) on its ability to market the relevant services.

The claimant (C) was an asset management company that entered into an outsourcing agreement with the defendant (D). The parties agreed to share revenue from D's selling C's exclusive business services to D's own clients. C could terminate the agreement if D ceased to carry on a material part of its investment banking business *and* that had an MAE on D's ability to market the services. D subsequently announced a strategy to exit or shrink unprofitable businesses, particularly its fixed income, currencies and commodities operations. C served notice to terminate the agreement. The court decided that "material" meant "significant" or "substantial" within the matrix of the agreement, following a line of case law including the first English case on an MAE termination right in 2013. The question of whether D had ceased to carry on a material part of the relevant business was objective not subjective, and the burden of proof was on C. The court found that there was no cessation of any specific part of the business on the facts, just a reduction in the business done in a particular department. There was therefore no need to address the issue of materiality. However, in line with the earlier 2013 case, the court commented that you would need an actual rather than a likely material impairment of D's ability to market the exclusive business services.
(*Decura IM Investments LLP v UBS AG, London Branch* [2015] EWHC 171(Comm))

Key lessons

- **Threshold to invoke an MAE termination right:** The case is useful in following the only previous English case on MAE termination rights and confirming that a high bar must be reached.
- **Test for ceasing to conduct a material part of a business:** The case confirms that the test is objective, with the burden of proof on the claimant.

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Penalty Implications of Upside Fee Arrangement and Support for Commercial Justification Test

In a case concerning an upside fee agreement in the context of finance arrangements, the High Court confirmed the support given by the Court of Appeal in a case in 2013 to the "commercial justification" test for assessing whether or not the primary purpose of a contractual provision is to deter the other party from breaching the agreement, amounting to an unlawful penalty.

Finance arrangements were entered into in relation to a property acquisition. The arrangements included an upside fee agreement between a lender (L) and borrower (B). The effect was that, in return for L arranging and providing the financing, a large fee was payable if certain payment events occurred. These included repayment of a junior loan in the structure. There followed breach of a personal loan agreement in the financing structure in favour of investors in properties owned by B. This entitled L to accelerate the junior loan agreement which, in turn, amounted to a "payment event" under the upside fee agreement. The court decided that L was entitled to receive the upside fee, and that this did not amount to a penalty. One factor was that the fee was payable on a variety of different triggers, not just a breach. Another was that the fee was not triggered on a breach of duty owed by the party claiming relief, but on a breach by other parties under a separate arrangement. Even if the rule against penalties had applied, the upside fee was commercially justifiable on the facts (a bridging loan entered into in the credit crunch and which was effectively a charge for providing the junior loan). An appeal hearing is awaited in relation to the judgment.
(*Edgeworth Capital (Luxembourg) S.A.R.L. and Another v Ramblas Investments B.V.* [2015] EWHC 150 (Comm))

Key lessons

- **Commercial justification test:** Statements in recent case law supporting the commercial justification argument were applied here.
- **Careful drafting:** Where the payment trigger is not expressed as a contractual breach, or that element is minimised by the presence of non breach-related triggers, you may reduce the risk that the payment amounts to a penalty.

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Contractual Provisions contd.

Disclaimers of Liability to Third Parties

Accountants recently got summary judgment on a negligence claim from a bank alleging it had relied as a third party on two non-statutory audit reports they had prepared for a common client. The reason was that the audit reports contained valid disclaimers of liability to third parties. The case raises issues analogous to those that could arise in relation to reports on a due diligence engagement.

The auditors (G) prepared the reports for the company Von Essen (VE). The bank (B) alleged that G had been negligent in failing to uncover fraudulent overstatements of VE's financial position by two of its employees. B said that the reports had been issued for providing information to banks as funders of VE, and that B had relied on them in continuing to fund VE under a £250m loan facility. It said that it had suffered loss because VE became insolvent and could not repay the loan. Both reports contained disclaimers that they were prepared solely for VE and its director and that "*to the fullest extent permitted by law*" G did not assume responsibility to anyone else. B alleged that the disclaimers were unreasonable under the Unfair Contract Terms Act 1977 (UCTA) and ineffective. One key factor in the court's decision was its view that the disclaimers were clear on their face. Other factors were that: the case involved sophisticated commercial parties; there was no engagement letter or fee arrangement between B and G; and it was well-known commercial practice for auditors to include these types of disclaimers. Between sophisticated parties these disclaimers were not unreasonable. (*Barclays Bank PLC v Grant Thornton UK LLP* [2015] EWHC 320 (Comm))

Key lessons

- **Positioning of disclaimers:** It is important to display disclaimers in clear and prominent positions.
- **Dissemination of reports:** The party relying on the disclaimer may consider the benefits of retaining control over the dissemination of its report to a third party in order to highlight the "no liability" basis.

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Validity of Earn-Out Notice under SPA

The Court of Appeal has considered whether a notice setting out a buyer's calculation of earn-out consideration payable under a share SPA complied with the SPA's requirements and whether, in any event, compliance was necessary for the notice to be valid.

Sellers (S) sold 50% of their shares in two companies to the buyer (B). The purchase price was structured as an earn-out. Under the SPA this had to be notified by B to S and calculated by reference to the pre-tax profits of the two groups as shown in the audited accounts for the two years ending 31 December 2011, failing which the matter had to go before an expert. B notified an earn-out calculation to S derived from September year-end accounts and adjusted by reference to management accounts. The Court of Appeal decided that this was not a valid earn-out notice for the purposes of the SPA because it substantially departed from the contractual requirements. The requirement of auditing was a protection of real importance to S rather than a mere formality. (*Treatt Plc v Barratt and Ors* [2015] EWCA Civ 116)

Key lessons

- **Comply with substantive content requirements:** It is important to comply with the content requirements for contractual notices, and the required basis of calculation of any monetary amount, not just the procedure and deadline for service.
- **Strict interpretation by the court:** The case shows that the court interprets such provisions strictly.
- **Separate audit required:** The buyer should have arranged a separate audit in order to comply with the earn-out requirements.

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Listed Companies

A number of decisions and regulatory announcements have highlighted issues crucial to listed companies

Market Abuse Directive Requires Information to be made Public even if Unknown How it will Influence Price of Financial Instruments

The European Court of Justice (ECJ) recently decided that information is sufficiently precise to come within the definition of inside information under the Market Abuse Directive (MAD) and the related implementing directive even if the information holder does not know the direction of any potential price change of the relevant financial instruments once the information is made public.

The judgment was given in response to a preliminary ruling arising from proceedings in France between Lafonta (L) and the French Financial Markets Authority (AMF). The AMF had fined L for failing to make public information relating to a financial operation which allowed Wendel SA, a French company specialising in investment and on whose board L sat as chairman at the relevant time, to acquire a significant shareholding in the Saint Gobain Group (SG). Over a period of time Wendel concluded total return swap agreements (TRSs) with four banks, the underlying assets of which were shares in SG. To hedge their positions, those banks acquired 85m shares in SG. At the same time Wendel obtained financing from the banks and another credit institution for a total amount close to that of the TRSs. Wendel subsequently decided to phase out the TRSs, and then acquired more than 66m shares itself, being 17.6% of SG's share capital. It notified the AMF as it passed thresholds of 5%, 10%, 15% and 20% in SG's share capital.

The issue was whether the information regarding Wendel's acquisition of a shareholding in SG had amounted to inside information in relation to Wendel's share price triggering disclosure obligations under MAD. The ECJ found that it had. It noted the AMF's findings that Wendel had intended from the outset of the financial operation to transfer its exposure to SG into an actual shareholding by acquiring the SG shares sold by the banks in the phasing out of the TRSs, and that had been the prime purpose of the operation (indeed, the related funding arrangement had enabled it to do so). The AMF had concluded that Wendel should have made public the principal characteristic of the financial operation by the date of concluding the TRSs and also the inside information as to Wendel's implementation of the operation for the purpose of acquiring a substantial shareholding in SG before passing the initial 5% threshold. The question before the ECJ was whether this information had been sufficiently precise to amount to inside information triggering disclosure obligations. The ECJ decided that the plain and ordinary meaning of the terms used in the MAD implementing directive show that it is enough for information to be sufficiently exact or specific to form a basis from which you can assess whether the circumstances or event in question are likely to have a significant effect on the price of financial instruments. The ECJ said that it is not necessary under the reasonable investor test in the implementing directive to be able to determine from the information the direction of change in the prices of the financial instruments concerned, nor the prices of related derivative financial instruments. The decision potentially lowers the threshold for determining what amounts to inside information requiring disclosure for the purposes of MAD. (*Jean-Bernard Lafonta v Autorité des Marchés Financiers* ECJ Case C-628/13)

Key lessons

- **Lowering of test for inside information:** The emphasis of the decision is on whether a reasonable investor would be likely to use the information when making his investment decision, rather than ability to determine the direction of a potential change in price.
- **Contrasts with decision of Upper Tribunal in *Hannam v FCA*:** The ECJ judgment contrasts with last year's Upper Tribunal decision that inside information had to both be precise and specific in the sense of indicating the possible effect on price.

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Listed Companies contd.

Public Censure for Failure to Treat Close Relatives as Concert Parties and Make Rule 9 Offer

The Takeover Panel issued a public censure of the chairman of AIM–traded Armour Group plc for failing to make a mandatory offer under Rule 9 of the Takeover Code and associated breaches of the Code resulting from an acquisition of shares in the company by his four sons.

In February 2011 the chairman (BM) and persons acting in concert with him acquired through a placing interests in shares carrying around 39.1% of the voting rights in the company (A). His concert parties included companies owned by trustees of trusts for the benefit of his sons. The Panel waived the requirement for BM to make a mandatory Rule 9 offer for the remaining share capital of A following a Rule 9 whitewash involving a vote of independent shareholders, as is usual practice in the context of a share issue. Later in 2011 BM turned down the opportunity to purchase shares holding a further 7.4% of the voting rights in A from investors who had originally participated in the placing. Instead he arranged for his sons to acquire those shares, gifting them the money to pay the purchase price. In deciding to issue a public censure of BM, the Panel's Executive emphasised that the sons were acting in concert with BM. Indeed, it is longstanding Panel practice to treat a person's close relatives as acting in concert with them, unless it is clearly demonstrated that the family relationship has broken down. This meant that the share purchases had been made in breach of Rule 5.1 of the Code, which prohibits a person that holds (together with his concert parties) between 30% and 50% of the voting equity share capital in a company from acquiring further voting shares. The share purchases had also triggered a further requirement to make a mandatory cash offer under Rule 9 which had not been made, and associated breaches of the requirement to make an announcement under Rule 2.2(b) of the Code immediately when an obligation is triggered under Rule 9. The Panel Executive had separately required BM to make a Rule 9 offer, noting that he was a principal member of the concert party, at the highest price paid by his sons between June and August 2011 and in the preceding 12 months. (*Panel Statement 2015/3: Armour Group plc*)

Key lessons

- **Consult the Panel:** People subject to the Takeover Code should obtain advice and consult the Panel on how provisions of the Code may apply to their transaction.
- **Concert parties:** It is longstanding Panel practice to treat a person's close relatives as their concert parties.

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Listed Companies contd.

Failure by Executives to Monitor Share Dealings: FCA Final Notice on Reckitt Benckiser

The FCA fined Reckitt Benckiser (RB) £539,800 for breaches of the Listing Rules, the Model Code and of DTR 3 on notification of transactions by persons discharging managerial responsibility (PDMRs). These related to inadequate systems and controls to monitor share dealings by its PDMRs in its own shares. This, in turn, had resulted in late and incomplete disclosure to the market of share dealings by two individuals.

One PDMR had used his shares as security for a credit facility. He apparently did not realise that this amounted to a dealing for the purposes of the Model Code even though in the past the FSA had specified this. Another PDMR had sold shares in RB which he held in the name of a private foundation in an offshore account. He was under the impression that he had oral clearance from RB to do so, although RB had not recorded this. RB subsequently made incomplete dealings notifications to the market. RB's share dealing policy largely followed the Model Code. It required PDMRs to seek clearance from the chief executive officer before dealing in shares, to complete a prescribed form in order to obtain that and to notify any dealing within four business days (also required by DTR 3). The FCA concluded that RB had breached the Listing Rules, the Model Code and DTR 3. Failures identified by the FCA included that RB was not properly monitoring share dealings by PDMRs and, consequently, was failing to identify breaches in a timely manner. If a PDMR's shares were not held in his own name, the intended safeguards did not work. The FCA also indicated that RB had wrongly allowed an informal process to develop for dealing. (*FCA Final Notice issued in January 2015 on Reckitt Benckiser*)

Key lessons

- **Training for PDMRs:** Training should be structured and regularly reinforced.
- **Follow share dealing policies:** Companies should not allow informal processes for dealing.
- **Records:** Companies should keep proper records.
- **Monitoring share dealings:** Companies should arrange to monitor dealings in PDMRs' shares, including where their shares are not held in their own name.

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New FCA Technical Notes on Share Buybacks, Disclosure of Lock-Up Agreements, Cancellation or Transfer of Listing and Discounted Share Issues

The FCA's Primary Market Bulletin 11 announced new technical notes on some key areas. Among other things, these cover: share buybacks; disclosure of lock-up agreements; cancellation or transfer of a listing; and standard of disclosure in circulars on discounted share issues.

The new technical notes cover, among other matters: share buybacks, indicating that the Listing Rules provisions on these will be applied by the FCA where a premium listed issuer proposes action which is a share buyback in substance, if not legal form; disclosure of lock-up agreements, including the FCA's view that variation, waiver or cancellation provisions which apply during the lock-up period are relevant information for disclosure purposes; cancellation or transfer of a listing, including the FCA's reluctance to reduce the 20 business day notice period; and discounted share issues, giving guidance on the requirements for the circular.
(*Primary Market Bulletin No. 11*, published on 30 March 2015)

Key lessons

- **Guidance on:**
  - **share buybacks:** even if only in substance, not form
  - **lock-up agreements:** increased disclosure obligations
  - **cancellation or transfer of a listing:** notice period
  - **discounted share issues:** requirements for circulars

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Listed Companies contd.

Private Censure of Nomad and Fine for Breaches of AIM Rules for Nomads

The London Stock Exchange (LSE) has announced the private censure and fine of £90,000 on a nominated adviser (nomad) for breaching Rules 16 (due skill and care), 17 (advising and guiding an AIM company) and 19 (Liaison with LSE) of the AIM Rules for Nomads.

The AIM company notified the market that it was due to receive certain material payments on a specified future date, but failed to notify the market when the payment was not made on the due date. The nomad did not advise the company to update the market, apparently thinking that this was unnecessary due to indications that the payment would be forthcoming in due course. The LSE disagreed, concluding that failure to update the market when the payment did not occur left investors with a misleading impression that payment had been received. The LSE took into account AIM Rule 10 which requires an AIM company to take reasonable care to ensure that any information which it notifies to the market is not misleading, false or deceptive and does not omit anything material. (*AIM Disciplinary Notice: AD13*)

Key lessons

- **Scenarios where notifications to the market should be updated:** Helpful examples of when the market should be updated are set out in the LSE's Notice.

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Company Law

There have been some particular cases of interest on different company law issues

Court Could Sanction Conditional Scheme of Arrangement where Appropriate

Although it is general practice for the court to require confirmation that all conditions have been satisfied or waived before it sanctions a scheme of arrangement, the High Court has confirmed that it can exercise its discretion to sanction a scheme that is subject to an outstanding condition where it considers it appropriate.

A company (C) wanted to pursue an IPO in the United States, together with a share listing on NASDAQ. It proposed a scheme of arrangement to redomicile its business through incorporating a new Cayman holding company (L) and exchanging shares in L for shares in C. Simultaneously, L was raising funds from new investors, which was essential to secure the NASDAQ listing. It was also crucial that the fundraising should not complete before the court had approved the scheme. The main issue was whether the court can in principle sanction a scheme where conditions remain unfulfilled. C proposed that the underwriters' obligations be made conditional on the change of domicile under the scheme having occurred, that the court should only be asked to sanction the scheme one day before the fundraising completed and that the court order should not be delivered to the Registrar of Companies until all the conditions of the fundraising had completed. The court sanctioned the scheme on this basis, taking into account that it was an internal corporate restructuring scheme, there were good commercial reasons for doing so, and that the fundraising would complete within the following 24 hours. In the unlikely event that it did not and the conditions were not satisfied, the status quo would simply be preserved. Although the case concerned a restructuring scheme rather than a scheme in connection with a takeover, similar issues can arise on a takeover in the context, for example, of a share for share offer, where the scheme may be conditional on the admission to listing of the consideration shares. (*Re Lombard Medical Technologies Plc* [2014] EWHC 2457 (Ch))

Key lessons

- **Schemes on takeovers:** Comparable issues can arise on schemes in the context of a takeover when subject to a condition on listing of consideration shares.
- **Condition conferring discretion on a third party:** By contrast, the court would be unlikely to sanction a scheme where the outstanding condition conferred on a third party the right to decide whether or when the scheme came into operation, or which allowed the terms of the scheme to be varied in some material respect.

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Proper Purpose for Member of Public to Inspect Register of Members

The High Court recently decided that a company did not have to comply with a request under the Companies Act 2006 (CA) to inspect or copy the register of members, where the request omitted information required by the CA. The request had in any event not been made for a proper purpose.

The request was made by a non-member who ran a tracing agency to trace lost members in public quoted companies. The court decided that it was invalid as it did not contain the name and address of any individuals with whom the defendant proposed sharing the information (as required by s.116 of the CA). The effect was that receipt of the request did not trigger the five working day period for the company to refer it to court for a determination that the request was not made for a valid purpose. The court also decided that the request had not been made for a proper purpose (taking the view that the real purpose here had been to extract a commission or fee from traced lost members of the company). The court took into account that the company had its own tracing agency with more favourable terms. The court confirmed that it applies an objective test for determining proper purpose, in the context of the company, its relationship with its shareholders, its trading and the request made. An appeal hearing is awaited in relation to the judgment. (*Burberry Group plc v Fox Davies* [2015] EWHC 222(Ch))

Key lessons

- **Request by non-member to inspect or copy register:** When the request comes from a non-member, the emphasis is on protecting shareholders as a class.

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Company Law contd.

Cross-Border Mergers Compliant with Companies (Cross-Border Mergers) Regulations 2007 Despite Shareholders of Transferor Companies Already Being Shareholders of Transferee LLP

The High Court approved two cross-border mergers that were intended to effect an internal reorganisation and decided that the consideration paid for the mergers complied with the Cross-Border Mergers Regulations, as amended for LLPs, even though the shareholders in the two overseas transferor companies could not become members of the English transferee LLP because they were already members of it.

The High Court was asked to approve two cross-border mergers under the Companies (Cross-Border Mergers) Regulations 2007 (Regulations) in order to effect an internal reorganisation. Under the draft terms of the mergers, it was proposed that these would be "mergers by absorption", where two German companies would each transfer all of their assets and liabilities to a single English LLP. Regulation 2(2)(f) of the Regulations, as amended for LLPs, requires that the shareholders of a transferor company become members of a transferee LLP as consideration for a cross-border merger. This regulation could not, however, be literally applied in this case because the transferor shareholders were already members of the LLP. The High Court nonetheless decided that the cross-border mergers complied with the Regulations, focusing on the fact that the draft terms of the mergers stated that the LLP would provide the shareholders with consideration by treating them as having made an "additional contribution" to the capital of the LLP equating with the nominal value of the share capital which they had held in the transferor companies and would also pay a nominal cash consideration to each shareholder. The court also found that the effect of the mergers was to ensure that the LLP was fully solvent and that there would be no adverse effect on any of the creditors of the merging companies or any other stakeholders. To refuse approval for the mergers would, therefore, lead to an "absurd result". (*Re Lanber Properties LLP & Lanber II GmbH* [2014] EWHC 4713 (Ch))

Key lessons

- **Purposive interpretation:** This case shows that the court is willing to apply a purposive interpretation to the Regulations, rather than a literal one.
- **No adverse effect:** A court will seek to satisfy itself that any merger will not adversely affect the interests of stakeholders before granting permission to a merger.

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Duties of Good Faith

A number of cases have looked at contractual duties of good faith or wider issues relating to the relationship between contracting parties

Scope of Power of Majority Shareholders to Bind Minority and Constraints on that Power

The Court of Appeal has rejected a shareholder's petition alleging unfair prejudice under section 994 of the Companies Act 2006 (CA) in connection with a forced share sale on the exercise of drag-along rights under articles of association and a related shareholders' agreement (SHA). The judgment contains a useful overview of the power of majority shareholders to bind a minority and the ambit of the constraints on that power.

D, a former director of C, the holding company for a private equity firm, brought a petition alleging unfair prejudice in his capacity as a shareholder in connection with a forced sale of his shares in C. D alleged that this had contravened the company's articles and an SHA and that amendments made to the articles in order to effect the forced sale were invalid. The amendments had revised pre-existing "drag-along" provisions in light of a forthcoming MBO transaction, and obliged shareholders to sell their shares in C if an offer to sell was accepted by the majority shareholders. The Court of Appeal decided that the power of majority shareholders to bind a minority by amending the articles was not without limitation. The power had to be exercised in good faith in the interests of the company. However, what is in the interests of the company and what amounts to a benefit to the company is for the decision of the shareholders rather than the court, unless no reasonable person would consider it as such. The court will not investigate the quality of the subjective views of shareholders. The burden of proof is on the person challenging the validity of the provisions. The Court of Appeal commented that shareholders' power to amend the articles can be validly exercised even if the amendment is not for the benefit of the company because it relates to a matter in which the company as an entity has no interest but, instead, is just for the benefit of the shareholders or some of them, provided that the amendment does not amount to oppression of the minority or is otherwise unjust or outside the scope of the power. (*Re Charterhouse Capital Limited: Arbuthnott v Bonnyman and Ors* [2015] EWCA Civ 536)

Key lessons

- **Power of majority to bind minority:** The judgment gives a useful overview of the scope of, and constraints on, the power of majority shareholders to bind the minority.
- **Power to amend the articles must be exercised in good faith:** However, it is a matter for the subjective judgment of the shareholders.
- **Transactions involving a forced share sale through use of drag rights:** The judgment is helpful in clarifying factors the court will take into account in determining the validity of changes to articles to facilitate drag rights on a transaction.

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Duties of Good Faith contd.

Power to Modify Terms of Loan Note Instrument Not Subject to Good Faith Term

The High Court decided that the power to modify the terms of a loan note instrument was not subject to an implied term of good faith, as there was no justification on the facts for implying this, particularly where the documented terms were detailed and extensive.

K, an acquisition vehicle, issued vendor loan notes (VLNs) to the claimants (M). This was part of the price for the sale of M's sub-prime lending business, S. K also issued discounted loan notes (DLNs) to the controlling investors in S, who were K's indirect shareholders. The DLNs were substituted at a later stage by follow on loan notes (FONs). The vendor loan note instrument entitled K to make any modifications to it if they were consistent in all material respects with any modification being made to the discounted loan note instrument. K purported to amend the vendor loan note instrument to subordinate the VLNs to the FONs and postpone the redemption date of the VLNs. The High Court declined to imply a term into the vendor loan note instrument that K's power to modify it had to be exercised in good faith for the benefit of the holders of VLNs and DLNs as a whole. A factor was that the documentation here was detailed and thorough, which reduces the likelihood that the court will imply terms. In any event, the VLNs and the DLNs did not constitute a single class. As non-parties to the VLNs, there was nothing to require the holders of DLNs to have regard to the interests of the holders of VLNs and owe them a duty of good faith when the DLNs were amended. As far as K was concerned, rather than being subject to an implied duty of good faith, its contractual obligation was instead to ensure that the VLNs were treated no differently from the DLNs. Previous case law implying a duty of good faith into long-term relational agreements had been heavily dependent on context. The court also pointed out that existing case law on the exercise of a contractual discretion distinguishes between a discretion involving a single decision and, by contrast, a discretion which involves a choice from a range of options. Here, there was no choice of options available to K.
(*Myers and Myers v Kestrel Acquisitions Limited and Ors* [2015] EWHC 916 (Ch))

Key lessons

- **Full and detailed documents:** The court is less likely to imply terms where the existing documentation is detailed and thorough.
- **Duty of good faith:** Previous case law on implication of a duty of good faith into long-term relational agreements did not lay down any general principle applying to all commercial contracts.
- **Exercise of contractual discretion:** The judgment gives a helpful overview of existing authorities on exercise of a contractual discretion.

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