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# 2020 Half-year in review M&A legal and market developments

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We set out below a number of interesting English court decisions and market developments which have taken place and their impact on M&A transactions. This review 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 common contractual provisions on M&A deals

### First English court interpretation of disproportionate effect carve-out exception to a Material Adverse Effect clause

On a trial of preliminary issues, the High Court recently interpreted an exception to a pandemic carve-out from a material adverse effect (MAE) definition in a share sale and purchase agreement (SPA), which applied where there was a disproportionate effect on the target, as well as a series of related drafting points on the SPA.

Buyer B bought two travel payment provider companies (T) from multiple sellers (S) for over US$1 billion. T was involved in facilitating online business to business (B2B) payments and credit arrangements, predominantly in the travel industry. The SPA was executed in late January 2020, shortly before COVID-19 was classified as a public health emergency and only a matter of weeks before it was classified as a pandemic. Critically, the SPA contained a condition to completion as to no MAE having occurred since signing, nor any event that would reasonably be expected to have an MAE. B invoked the MAE condition to try to avoid closing the acquisition. Although the definition of MAE carved out conditions resulting from pandemics, a carve-out exception applied

### Key lessons

- **Unique facts, but wider implications:** The facts of this case were unique, given that the SPA was entered into in late January 2020, just before the COVID-19 crisis hit globally. This meant that the buyer could argue it neither knew of, nor accepted, the risks from the consequences of COVID-19 on the target businesses when it signed the SPA. Irrespective of this unique aspect, the case raises drafting issues of wide generic application.
- **Express drafting needed for disproportionate effect comparator:** Parties should expressly define what they intend for the comparator. The court noted that had not happened here and suggested future drafters may now do differently.
- **Overlapping heads of carve-out:** Where multiple heads of carve-out may be triggered by similar or overlapping events, it is better for the buyer if all, not just some, of them are brought within express carve-out exceptions and treated the same way.

(continued overleaf)

where there was a disproportionate effect on the target groups "*taken as a whole, as compared to participants in the industries in which [they] operate*". One key issue was what "industries" meant for the purposes of this "disproportionate effect" comparator. The High Court decided that it meant the widely-recognised B2B payments industry, taking the view that there was no "travel payments" industry as such. The court said that, whilst the alternative expressions of "markets", "sectors" and even "competitors" would suggest a disproportionate effect triggered only by firm-specific issues, by contrast "industry" caught participants in a far broader sphere of economic activity, including entities in a supply chain. It connoted scale and generality. The court took the view that, in effecting the acquisition, B had seen value in reaching into the wider payments industry. It rejected that a comparison necessarily suggested very similar companies or being affected consistently. The effect was that the carve-out exception could be engaged by a disproportionate effect compared to a much wider industry than the beleaguered travel industry which had suffered so deeply in the pandemic. This favoured B. The court also considered a range of wider issues on MAE clauses. It denied that there are any special rules of construction, including that an exception should be construed against the party relying on it. The burden of proof is on seller for carve-outs and buyer for carve-out exceptions. Whether an event was excluded from amounting to an MAE by a separate carve-out from the definition which applied on a "change in law" was determined solely by whether the event resulted from a matter within that carve-out. The effect was that a change in law or regulatory conditions literally fell solely within the "change in law" carve-out (to which there was no exception), rather than the pandemic carve-out (which benefited from the exception). It did not matter whether the worldwide collapse in travel arose from the imposition of legal restrictions such as those on travel, lockdown and quarantine which themselves resulted from the pandemic. This, in turn, favoured S. (*Travelport and others v WEX Inc* [2020] EWHC 2670 (Comm))

- **Prospective versus retrospective effects:** The judgment separately highlights the merits of consistency over whether prospective effects are caught within an MAE definition and related carve-outs and carve-out exceptions respectively.
- **Trial of preliminary issues:** The ultimate outcome in this case remains to be seen. This was a trial of preliminary issues. Although the decision on the "disproportionate effect" comparator to apply was in the buyer's favour, the decision on treatment of overlapping heads of carve-out favoured the seller.

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## Tax covenant claim barred for inadequate notice of claim

A buyer's tax covenant claim under a share SPA was unenforceable because its notice of claim failed to comply with the notice requirements of the seller limitations in the SPA. This meant that the sellers got summary judgment on their claim for the release of US$50 million from escrow.

The buyer (B) acquired the holding company of the target group from multiple sellers (S). The dispute related to a tax covenant claim and the main issue was whether or not B had complied with the requirement in the seller limitations in the SPA for it to give written notice of claim stating "*…in reasonable detail the matter which gives rise to [the] Claim [and] the nature of such Claim…*" prior to the second, and final, escrow release date (30 June 2019). After completion, Slovenian tax authorities instigated an investigation into transfer pricing practices of a member of the target group. While this was still ongoing, B served notice of claim on S on 24 June 2019 specifying that the claim related to the investigation in progress and indicating a claim of an amount equal to any ensuing tax liability to be imposed following the investigation. The High Court granted S summary judgment on the basis that B's notice of claim was deficient. It decided that "matter" giving rise to the claim meant the underlying facts, events and circumstances constituting the factual basis of the claim and giving rise to (or which in future may give rise to) a tax liability on a group company. You had to

### Key lessons

- **Mandatory requirements:** To preserve its claim, a buyer must strictly comply with the requirements for notices of claim agreed in the seller limitations in the SPA by the longstop deadline set. These requirements will be treated as mandatory.
- **Seller's knowledge not relevant:** The level of background knowledge of the seller and/or its representatives is generally irrelevant for this purpose.

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indicate how the claim arose out of the identified facts. Merely notifying the existence of the tax investigation was not enough, because it did not identify the transfer pricing practices or transactions in question nor what had come to light in the investigation. You had to consider how a reasonable recipient would have understood the terms of the notice of claim. Its driver was the need for commercial certainty so that a seller could assess and deal with a claim.

The court also denied that the notice of claim should be construed in light of the knowledge of S's representatives, not least because there was nothing in it to incorporate by reference discussions or exchanges outside the notice. Leave has been granted to appeal the decision. (*Dodika Ltd. and others v United Luck Group Holdings Ltd.* [2020] EWHC 2101 (Comm))

## Interpretation of seller limitation in relation to claims for lost goodwill

The Court of Appeal decided that a share buyer's claim for breach of a warranty as to honest and careful preparation of financial forecasts was not barred by a seller limitation in the SPA in respect of claims for lost goodwill.

Buyer B bought two aerospace manufacturing companies, one based in the UK and the other in Thailand, from seller S. The plan was to move operations to Thailand in the future. The companies were loss-making at the time of the sale. B discovered major operational problems after completion and claimed for breach of a warranty in the SPA that financial projections provided to it had been honestly and carefully prepared. B alleged these overstated both future profitability and the pace at which the move to Thailand could happen. S argued that the claim was precluded by a seller limitation which applied to the extent that a claim was in respect of lost goodwill. S alleged that loss of goodwill should be construed broadly in line with the accounting definition, to cover a loss of share value where that value represents the difference between the fair value of the identifiable net assets acquired and the price paid for the business on acquisition and/or the loss of share value is caused by the impairment of the value of the non-identifiable assets. B argued that the seller limitation did not apply, because its claim was unconnected with lost business reputation. The Court of Appeal decided in B's favour. In the context of the sale of a business, the long-established meaning of goodwill was a proprietary right representing reputation, good name and business connections of the relevant business. There was no reason here to depart from the ordinary legal meaning of the term, nor to apply the accounting definition. If the parties wanted to give an unusual or technical or non-legal meaning to a contractual provision, they needed to do so expressly. The purpose of the seller limitation for lost goodwill was to exclude any claim for damages to B's own reputation, for example, if a target company had been convicted of money laundering and failed to disclose that. S's interpretation would significantly cut back B's remedies, because any warranty claim not relating to a target company's existing net assets at the sale date would be excluded. Clear and express language was needed to show that was intended. It was also relevant that the term "goodwill" was used elsewhere in the SPA to mean reputation, name and connections, particularly in the non-competition covenants, where it extended to future as well as current value. (*Primus International Holding Co and others v Triumph Controls UK Ltd.* and another [2020] EWCA Civ 1228)

### Key lessons

- **Scope of limitations on liability:** Clear and express drafting is needed to delineate the scope of a limitation on liability, particularly if it is intended to depart from the ordinary legal meaning.
- **Contractual interpretation:** The judgment demonstrates that the court will interpret contractual provisions in the round, taking into account usage of a particular term in different clauses in the agreement. Where a different meaning is intended, alternative terminology and express language should be used.

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### Interpretation of tax gross-up clause in SPA

The High Court decided that the words "subject to taxation in the hands of the receiving party" in a tax gross-up clause in an SPA meant amounts actually taxed and not merely within the scope of a tax and not exempt.

A dispute arose on the interpretation of a tax gross-up clause in an SPA. The issue was how to apply this in the context of a contractual obligation in the SPA on the seller (S) to reimburse the buyer (B) 90% of losses arising from mis-selling of payment protection insurance (PPI) by the target companies. The relevant provision was clause 18.5 of the SPA, which stated that, if any sum payable by a party under the SPA "*…is subject to taxation in the hands of the receiving party, the payer shall [be under the same obligations, as under clause 18.4 above, to] pay an additional amount in relation to that taxation[, as if the liability were a deduction [or] withholding required by law]*". The aim was to increase the net amount of a payment up to the gross amount before tax. The preceding clause 18.4 provided separately for an additional payment to be made when an actual withholding of known tax was required by law. The High Court decided that "*subject to taxation in the hands of the receiving party*" for this purpose meant actually taxed in their hands, not just within the scope of a tax and not exempt. There would not otherwise be a sum "*in the hands of the receiving party*" that was being taxed. The additional payment to gross up for tax in hand only became due when the receiving party was under an enforceable obligation to pay an actual amount of tax. On the facts, this was the ordinary and natural meaning of the drafting of this particular clause, required no extrapolation, re-writing or additional words and made commercial sense. The aim of the clause was to make sure that the recipient was neither out of pocket nor overpaid. The parties should have specified expressly if they had wanted the gross-up to be paid before an actual tax burden arose and was known. It made no sense to apply the timing provision in clause 18.4, which was based on an actual tax deduction, to an additional payment under clause 18.5 before there was an actual tax liability. (*AXA S.A. v Genworth Financial International Holdings, LLC and another* [2020] EWHC 2024 (Comm))

**Key lesson**

- **Clear and express drafting:** The judgment shows the importance of clear and express drafting in the SPA of parties' intentions as to contractual risk allocation.

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### Contractual requirement not to unreasonably withhold consent

The High Court decided that a contractual provision requiring a party's consent, such consent not to be unreasonably withheld, did not entitle the holder of that discretion to make its consent conditional on the other party agreeing to pay an increased tariff.

Under a transport and processing agreement (TPA) AP was entitled to move oil through three oil fields in the North Sea via a pipeline system known as FPS and run by IN. The fixed maximum transportation quantity was derived from AP's estimated quarterly production profile, as set out in Attachment F to the TPA. Under the TPA, AP was entitled to amend this subject to availability of uncommitted capacity in the FPS and subject also to IN's consent, "*such consent not to be unreasonably withheld*". IN was reinvesting in the programme to extend the FPS into the 2040s. AP wanted to amend the production profile to extend it from January 2021 to December 2040. IN would only consent to this if AP agreed to increase the base tariff payable under the TPA. On a trial of preliminary issues, the High Court decided that IN was acting unreasonably and uncontractually. The TPA entitled and required AP to move its North Sea oil through the FPS at the contractual tariff for the duration of the TPA, which continued until it was terminated on one of six bases. Attachment F did not limit that right and obligation to the period up to 2020, and amending that Attachment did not change this. The court had to construe a contractual discretion in the context of the contract as a whole and ensure that the discretion-holder did not override or nullify a contractual right conferred elsewhere, and in more specific terms, in the contract. You had to distinguish between imposing a condition designed to compensate

**Key lessons**

- **Court will consider contract in the round:** The court will consider the contract as a whole and in the round, rather than just the clause providing for the relevant contractual discretion, when assessing the extent to which consent may be withheld.
- **Contract terms may not be reopened:** The discretion-holder may not reopen the contract terms as a condition of granting its consent.
- **Factors to be taken into account:** Consider expressly specifying the factors that the holder of a contractual discretion may take into account.

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a discretion-holder for losing a benefit it enjoyed under the contract (such as a guarantee to secure the worth of an assignee's covenant where it would be a financially weaker party) from imposing a condition which (as here) would impair a right the counterparty had under the contract. The former might be allowed in limited circumstances, but the latter was not allowed. The tariff in the TPA was a central aspect of the parties' bargain which could only be revisited in specific limited circumstances. (*Apache North Sea Ltd v INEOS FPS Ltd.* [2020] EWHC 2081 (Comm))

### Restraint of trade doctrine did not apply to services agreement in connection with a restructuring and joint venture

The High Court decided that the restraint of trade doctrine did not apply to restrictive covenants in a services agreement entered into in connection with a restructuring and joint venture, even though they could potentially run for one hundred years.

There was a restructuring of the businesses of several private companies providing actuarial services. When the parties' interests diverged they could not afford a buyout. Instead, a new limited liability partnership (L) was formed. Under a services agreement, L was entitled to run the parties' legacy business potentially for 99 years as their agent (together with a similar business itself), with the original owners keeping their own name and existing clients, for a fixed 57% of fee income. L covenanted in the services agreement not to provide services to existing clients of the legacy business, nor to solicit them, other than on the existing owners' behalf for a term that could potentially run for 100 years. L now argued that the covenants were an unenforceable restraint of trade, focusing predominantly on their duration. The High Court upheld the covenants and decided that the restraint of trade doctrine did not apply. You had to look at the services agreement in context. It was a bespoke agreement designed to address the competing needs and interests of professional people, and you could not pigeon-hole it. It was significant that L had been formed for the purpose of the restructuring. Its sole purpose was to conduct the legacy business. It had no prior being or business. The services agreement was not a restraint of trade, but a way of facilitating L to trade on its own account. The court also took into account that the original negotiation had been for a ten-year term, but this had been extended on L's instigation due to its concerns that a short period might prejudice it if clients withdrew soon after it commenced trading. The parties were sophisticated people who could look after their own interests. Other factors were that the parties had acknowledged in the services agreement that the covenants were fair and that L had only paid to use the legacy business, not to acquire it. The negotiated restrictive covenants gave effect to "ownership boundaries" and L could not have the best of both worlds. There were also no public policy factors rendering the restrictive covenants unreasonable. Leave has been granted to appeal the decision. (*Quantum Advisory Ltd. v Quantum Actuarial LLP* [2020] EWHC 1072 (Comm))

#### Key lessons

- **Enforcement of restrictive covenants:** The court remains more liberal in scrutinising and enforcing restrictive covenants in commercial agreements than in employment contracts, where there may be particular risk of unequal negotiation leverage.
- **Reasonableness and protection of legitimate business interests:** Between sophisticated parties, generally the court will uphold restrictive covenants that are reasonable with reference to the interests of the parties and the context of the overall arrangements and are entered into to protect a legitimate business interest.

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### Interpretation of formula consisting of narrative and two worked examples

The High Court decided that, where worked examples in an appendix to an agreement contained two steps that were not expressly set out in the preceding narrative part of the formula in the body of the agreement, the sums should be calculated in accordance with the worked examples.

P chartered a boat from A. A dispute arose over the amount of the reduction or upward adjustment of the daily hire and how this was to be calculated under Appendix M to the charterparty agreement. The formula consisted of a narrative in the body of the agreement and the two worked examples in Appendix M. A supremacy clause said the main body of the agreement prevailed on a conflict over the appendices. The worked examples contained two further steps not expressly provided for in the narrative in the main body of the agreement. These lowered the "pivot point" above which the daily hire would increase. This meant that P had to pay increased daily hire even when the boat's availability was at or below target level. The High Court decided that the hire should be calculated in accordance with the worked examples. It took the view that the formula allowed for the finer details of the calculation to be set out in these examples. You had to look at the objective meaning of the charterparty language in the commercial context and against the backdrop of the agreement as a whole. The court took into account that a number of changes had been made in the course of drafting without the consequences being consistently followed through, such as needless repetitions and references to a non-existent example. There was no real inconsistency between Appendix M and the narrative. Just because the narrative did not provide for the calculations in the extra steps was not a reason to disregard them. The effect was that the supremacy clause was not relevant. It also took into account that the presence of the disputed step in two worked examples suggested it was a deliberate choice by the drafter. The court would not rewrite a contract where it was not clear that something had gone wrong with the language. (*Altera Voyageur Production Ltd. v Premier Oil E&P UK Ltd.* [2020] EWHC 1891 (Comm))

#### Key lessons

- **Treatment of worked examples:** Care should be taken when including worked examples, as the judgment shows the significance that may be placed on them.
- **Number of worked examples:** The decision shows the merits of including more than one worked example to bolster enforceability.
- **Consistency:** As a drafting matter, ensure consistency between worked examples and related narrative and that any amendments to the main formula in negotiation are reflected in the worked examples.
- **Supremacy clauses:** It is advisable to provide expressly which provision prevails on a conflict, even though the supremacy clause was not applied on the facts of this case.

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## Company law

There have been particular cases of interest on a number of company law issues

### COVID-19 driven modifications to scheme of arrangement after shareholder approval

The High Court approved modifications to a scheme of arrangement after it had been approved by shareholders, where the changes were driven by the COVID-19 pandemic, sanctioning the scheme and approving the related reduction of capital.

A plc was listed on the New York Stock Exchange (NYSE). A scheme of arrangement was proposed to introduce a new holding company (H), also to be listed on the NYSE. Ordinary shares in A plc with a nominal value of US$ one cent each held by scheme shareholders were to be cancelled

#### Key lessons

- **Provide for modification:** The case demonstrates the importance of expressly allowing for modification in scheme terms, as had happened here. The scheme terms allowed for this where both parties agreed and the court consented.
- **Same overall outcome:** It is noteworthy that the main modification was designed to secure the same outcome as the overall reorganisation anyway with regard to the ultimate nominal value of scheme shareholders' shares in the new holding company.

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and the reserve arising on cancellation applied in paying up new shares to be issued to H. Scheme shareholders would instead be issued shares in H in the same proportions as they currently held their shares in A. The original intention was that these would be issued with a nominal value of US$150 per share, which subsequently would be reduced to US$ one cent under an Irish law reduction of capital designed to create distributable reserves. After the scheme was easily approved by shareholders, A and H agreed modifications. One change was to issue the shares in H with a nominal value of US$ one cent at the outset. Another was to change the record time to reflect the closure at the time of the London branch of UK Companies House due to the pandemic (which potentially delayed when the scheme would take effect). The High Court allowed the modifications and sanctioned the scheme. The test was whether the change would have caused a reasonable shareholder to take a different view on the scheme, which the court decided it would not. The changes were driven by the COVID-19 pandemic and the recent collapse in oil price. One aim was to avoid the risk that the nominal value of the new shares in H would be higher than the share price of the scheme shares, meaning they might not be issued fully paid and, consequently, might be ineligible to list on the NYSE. This could not be ruled out due to the high market volatility at the time. Another was to avoid the risk of delays to Irish court approvals due to the pandemic. (*Re Aon plc* [2020] EWHC 1003 (Ch))

## Single class on scheme of arrangement despite different contractual arrangements

On a scheme of arrangement to reorganise Organic Milk Suppliers Co-Operative Ltd (O), the High Court decided that all shareholders formed a single class for the purposes of the court meeting to vote on the scheme, because their position was the same in relation to the different pre-existing contractual arrangements held by shareholders.

O's principal business was buying scheme shareholders' milk and selling it into the dairy market in a way designed to maximise the return to members and give them the security of a long-term market for their milk. Membership was conditional on being a party to a milk contract with O. Each member held ten ordinary shares. The aim of the reorganisation was to improve members' returns on the milk they produced. The effect of the scheme was that scheme shareholders would become shareholders in a new holding company limited by guarantee (H). This would become the new market-facing trading entity. Out of over 200 scheme shareholders, four were founder members holding some enhanced rights under O's articles of association as well as different types of milk contracts. However, under the proposals all scheme shareholders' milk contracts would simply be novated to H with some variations across the board, whichever variant contract format they held. Shareholders who did not wish to be bound by the new contracts could terminate. The High Court decided that all scheme shareholders formed a single class and sanctioned the scheme. You had to look at what happened to members' rights as a result of the scheme. It was key that founders' rights would be preserved under H's articles of association and that founders were not being paid to surrender rights nor getting different rights. This meant that all scheme shareholders could consult together in a single meeting with a view to their common interest when voting on the scheme. The analysis was the same in relation to the different types of milk contract. The members all had the same broad question to consider. Class constitution is not affected where members have similar rights under a proposed scheme but just different commercial interests. (*Re Organic Milk Suppliers Co-Operative Ltd.* [2020] EWHC 1270 (Ch))

### Key lessons

- **Guidance on class composition:** The judgment gives useful guidance that members will be treated as forming a single class, despite enhanced rights which some may have, where existing rights will all be treated in the same way.
- **Commercial interests:** The judgment highlights that differing commercial interests do not affect this analysis.

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### Statutory requirements met for scheme of arrangement despite alleged lack of notice of beneficial owners

The High Court has sanctioned a scheme of arrangement despite objections alleging that most beneficial owners did not find out about the scheme in time.

The proposed scheme would allow A plc to acquire S plc, where objections had been raised. A number of members of S were nominees for large volumes of beneficial owners, tens of thousands of whom were small investors who had bought their shares in a 2019 share offering at a price exceeding 20 pence per share. Under the scheme, investors would only receive 5.5 pence per share. The beneficial owners alleged that they had not found out about the proposed scheme from their nominees and had not seen S's social media posts or advertisements in national and local newspapers. They also argued that the scheme would cause grievous loss to people who could not afford to lose their investment. The High Court nonetheless sanctioned the scheme. One factor it took into account was that, if the scheme did not go ahead, investors would likely get even less than 5.5 pence a share or nothing, as S would be expected to go into administration by the end of the month. Another was that 5.5 pence was a significant premium to the current share price. The court emphasized that scheme documents have to be sent to registered members not beneficial owners of shares. A member of a company is a person who has agreed to become a member and whose name is entered on the register of members. Just because beneficial owners may not have found out about the scheme in advance was not directly relevant to assessing fair representation of members at the court meeting. Even if beneficial owners had been informed, there was no knowing what the outcome of the vote would have been and the objectors may not have been representative of the majority. From the sizeable number of speakers and votes against the resolution at the court meeting, the court was satisfied that members had been fairly represented. Members had voted in good faith to salvage such value as could be salvaged. The court also confirmed that there was only one class of members for the purposes of the scheme. All registered members had the same rights under S's constitution and would have the same rights under the scheme. (*Re Sirius Minerals plc* [2020] EWHC 1447 (Ch))

#### Key lessons

- **"Member" for purposes of scheme:** The judgment emphasizes that, for the purposes of a scheme of arrangement and, more generally, under the UK Companies Act 2006, "member" means registered member.
- **Court sanction:** The court will sanction a scheme of arrangement where it is satisfied that the statutory requirements were met and that members approving the scheme voted in good faith.

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### Shareholders' unanimous consent by beneficial owner could grant ostensible authority

The Privy Council decided that informal shareholders' unanimous consent could be given by a beneficial owner of bearer shares and that such unanimous consent could be used to grant ostensible authority.

B was beneficial owner of bearer shares in a British Virgin Islands (BVI) company (C). B had originally acquired C on instructing his associate S to arrange for a US lawyer to buy a BVI-registered company. Evidence suggested his aim was to put his assets beyond the reach of creditors and stay out of the limelight. The lawyer had organised this through a corporate services company (Agent) which, in turn, had appointed an associate of its own as director (D). C's sole purpose was to hold land, which was its only asset. Over a period of two years D had granted four powers of attorney (PsoA) on behalf of C, on S's instructions. S now instructed D to grant a fifth PoA to a lawyer, this time to sell the land. S repaid himself from the sale proceeds debts that he alleged were owing to him, including arrears of salary. The Privy Council rejected B's challenge to the land sale. It decided that B's behaviour had amounted to a representation by conduct by C, through B, to both D and the Agent that S had authority to instruct the PsoA. S had actual authority to issue

#### Key lessons

- **Unanimous consent of beneficial owner of shares:** This is a rare judgment confirming that unanimous consent of beneficial owners (rather than registered owners) can be sufficient, where appropriate.
- **Ostensible authority:** It is also useful in clarifying that the shareholders' unanimous consent principle can apply to the grant of ostensible authority.

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instructions for the first four PsoA and ostensible authority for the fifth. B's representation by conduct included: setting up a system where all his instructions were given by S; making it clear that he wanted to stay out of the public eye; and the course of dealing over the past two years, which B had never questioned. Applying the shareholders' unanimous consent principle, C was bound by the decision if B, as sole beneficial shareholder, had consented to S's authority. B was treated as having informally so consented. The ostensible authority conferred by B amounted to ostensible authority from C. Consent of a beneficial owner was enough where the beneficial owner was taking all the decisions on the transactions. (*Ciban Management Corporation v Citco (BVI) Ltd. & another* [2020] UKPC 21)

## Listed companies

The following FCA and LSE decisions are of particular interest to listed companies

### Compensation scheme and censure for issuer publishing false financial results

An AIM company (R) has agreed to compensate investors, and was censured by the Financial Conduct Authority (FCA), for publishing half-yearly and annual results which contained false information.

In November 2016, R announced that it had identified misstated accounting balances, begun a forensic review and served notice on its CFO. The price of R's shares fell by about 62% during the course of that day. It later became apparent that R had significantly understated its net bank debt and overstated its cash and cash equivalents in its half-yearly results in 2015 and annual results in 2016. At the time the civil offence of market abuse included the dissemination of information which gave, or was likely to give, a false or misleading impression as to certain qualifying investments (e.g. shares admitted to trading on AIM) by a person who knew or could reasonably be expected to have known that the information was false or misleading (s.118(7) of the Financial Services and Markets Act 2000 (FSMA 2000)). In July 2016 this was replaced by broadly similar wording in Article 12(1)(c) of the Market Abuse Regulation (MAR).

The FCA found that R had committed market abuse under s.118(7) of FSMA 2000. R co-operated with the FCA's investigation, immediately commissioned an independent forensic review and improved its systems and controls which the FCA said "had clearly not been effective to prevent the deliberate misconduct in this case." R agreed to pay about £11.4 million to net purchasers of shares between its half-yearly results announcement and its November 2016 announcement. No doubt R had the FCA's power to require restitution under s.384 of FSMA 2000 in mind when it agreed to this. The FCA publicly censured R. In the unique circumstances of this case, it was preferable for R to use its resources to compensate investors, rather than for the FCA to impose a penalty which would risk causing disruption to R's business and customers. The FCA noted that R provided managed IT services, its customers included numerous NHS Trusts and it was providing vital services in respect of the COVID-19 pandemic. (*FCA final notice to Redcentric plc* – 26 June 2020)

#### Key lessons

- **Executive involvement – procedures and controls:** This decision, the immediate departure of R's CFO and the FCA's comment about "deliberate misconduct" underlines the importance of listed and AIM companies having sufficient procedures, systems and controls in place.
- **Pro-active and timely response:** If serious concerns arise and the facts are unclear, then swift action is needed. In this case, R's co-operation with the FCA, immediate commissioning of an independent review and voluntary agreement to a compensation scheme contributed to a better than expected regulatory outcome.
- **FCA focus on misleading information:** This is another example of FCA enforcement action for disseminating false or misleading information in contravention of s.118(7) of FSMA 2000. We expect that the broadly similar replacement provision (Article 12(1)(c) of MAR) will become a similarly important enforcement tool for the FCA.

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### Prohibition and censure for executive regarding misleading AIM admission documentation and accounts

The former CEO (C) of an AIM company (W) was the subject of a prohibition order and censure by the Financial Conduct Authority (FCA) in relation to misleading AIM admission documentation and annual accounts.

C was the CEO, co-founder and largest shareholder of W, a supplier of spread betting products. He was closely involved with drafting and approving the formal admission documentation for W's AIM flotation in August 2007. In September 2006 certain W executives (including C) made significant loans to W and its subsidiaries (the internal loans). Until at least 2009, certain W executives (including C) personally acted as a hedge for considerable trading exposures generated by selected positions provided to clients by W subsidiaries (the internal hedging). The internal loans and internal hedging were not disclosed in W's admission documentation, nor its annual accounts. Between January 2010 and March 2012 large spread-bets on W shares were placed on the trading accounts of five W clients. The spread-bets on two accounts were placed by C without the clients' knowledge. Transactions on all five accounts were inconsistent with statements in W's annual accounts regarding its credit policy. In March 2012 C resigned as W's CEO, W identified possible financial irregularities, and administrators and receivers were appointed soon afterwards.

The FCA found that C had committed market abuse under s.118(7) of FSMA 2000. C was aware that W's AIM admission documentation and annual accounts failed to disclose the internal loans and internal hedging, and did not accurately describe W's credit policy. The FCA considered that C disseminated information under s.118(7) of FSMA 2000 by providing misleading information as part of W's admission documentation and by its subsequent failure to accurately disclose matters in its annual accounts. As the CEO and an approved person, the FCA found that C bore responsibility for the accuracy of W's AIM admission documentation and the annual accounts. The FCA had originally decided to fine C £658,900. However, C provided verifiable evidence that any fine would cause him serious financial hardship. Accordingly, the FCA's Final Notice only publicly censured C and prohibited him from performing any function in relation to regulated activities. (*FCA final notice to Conor Martin Foley* – 7 September 2020)

#### Key lessons

- **Executive involvement – procedures and controls:** The involvement of multiple executives in the internal loans and internal hedging emphasizes some of the challenges that listed and AIM companies may face in consistently implementing procedures, systems and controls.
- **Robust verification and good records:** This underlines the importance of empowering other personnel and advisers to ask pertinent questions during the preparation and verification of admission documents and annual accounts, and to follow up any inconsistencies or concerns. Adequate records of these processes should also be maintained.
- **FCA focus on misleading information:** Over the years the FCA has taken enforcement action against a number of executives for disseminating false or misleading information in contravention of s.118(7) of FSMA 2000. This includes W's CFO and the Financial Controller of a W subsidiary in April 2017. We expect this practice to continue under the broadly similar replacement provision (Article 12(1)(c) of MAR).

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## Issuer fined for inadequate procedures, resources and controls regarding financial information

The London Stock Exchange (LSE) has censured and fined an AIM company (Y) for failing to have in place sufficient procedures, resources and controls in relation to financial information, and for announcing inaccurate forecasts. However, in this case the LSE waived the fine.

During the first half of 2018, Y's announcements included a number of forecasts (based on internal management information) that its full year profits before tax would exceed market expectations. This was during a period of exponential growth of Y's business. In October 2018, Y identified errors in its previous management information which impacted its profitability. Y announced that there was likely to be a £10 million negative adjustment in pre-tax profitability, when compared with previous market expectations, and Y's share price fell significantly (about 80% that day). Y then commissioned an independent forensic review which identified weaknesses in the operation of its financial reporting systems.

The LSE censured and fined Y £300,000 for failing to have in place sufficient procedures, resources and controls to enable it to comply with the AIM Rules (in breach of AIM Rule 31), and for making inaccurate announcements (in breach of AIM Rule 10). However, in this case the LSE waived the fine. It had regard to the uncertainties and potential financial challenges for Y arising from the impact of COVID-19. The LSE found that Y was focussed on rapid expansion and growth. However, there was no commensurate development of its financial control environment. The quality and accuracy of aspects of Y's financial and management information had not kept pace with its growth trajectory and changes to the profile of its business. The LSE emphasized the fundamental importance of AIM Rule 31. It is not enough for AIM companies to have documented procedures and protocols in place. These should be appropriately reviewed and developed so that they are effective in practice (on a continuous basis) and are adapted to adequately address changes. Boards should be appropriately engaged in evaluating their effectiveness. (*LSE AIM disciplinary notice AD 23 regarding Yü Group PLC* – 10 August 2020)

### Key lessons

- **Adapt procedures and controls to changes:** This decision underlines the importance of adapting procedures, resources and controls in response to the growth and development of a company's business. This can be a particular concern for companies which are growing rapidly, whether organically or through acquisitions.
- **Risks when generating forecasts:** Considerable care is required when generating forecasts relating to future financial performance. This is even more important if any forecasts are to be publicly disclosed. Before deciding to disclose the company should consider this and other potential legal issues, e.g. if the company subsequently issues a prospectus or becomes involved in a takeover.

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## Good faith

A recent case has looked again at contractual duties of good faith and the relationship between contracting parties

### Breach of express duty of good faith in shareholders' agreement

The High Court found that an express duty of good faith in a shareholders' agreement had been breached where a minority shareholder was dismissed as employee/director without warning and compulsorily bought out at a discount under bad leaver provisions.

M held 20% of the shares in company C, whilst B held 80%. M was employed by C's subsidiary S and director of both companies. S's main business was providing heating and ventilation systems. M's employment contract could only be terminated on three months' notice, save in certain scenarios such as gross misconduct by M. A disciplinary mechanism with a set procedure applied under M's employment contract. Under clause 19.2 of their shareholders' agreement (SHA) each shareholder agreed to act at all times in good faith towards the other and to use all reasonable endeavours to ensure that the provisions of the SHA where observed. Disagreements arose after B established a corporate venture with a third party. B wanted a member of C's group to take a minority stake in this, with a view to selling the combined business. B terminated M's employment without warning nor allowing M to respond to allegations of poor performance by him on six of S's projects which he had supervised, including damage to a customer's property and alleged harm to S's reputation. B compulsorily acquired M's shares at a discount applying to bad leavers. The High Court decided that M's dismissal as a bad leaver without warning nor investigation nor considering remedial action was a breach of B's express duty of good faith in the SHA. This imposed on a defendant certain minimum standards of behaviour, including to deal fairly and openly and to have regard to the claimant's interests, whilst of course still entitled to take their own interests into account. "Fair and open" dealing in the context of a decision meant giving the claimant a fair warning, an opportunity to put their case before the decision was made and considering it with an open mind. This had not happened here. The express duty of good faith extended to all significant decisions in relation to the business and M in particular. It did not matter that B believed that M's dismissal was in the group's best interests, nor that the evidence suggested that B could have achieved the same outcome in a procedurally compliant way. The result was that M was entitled to damages calculated by reference to the likely negotiated fair value of the shares. Leave to appeal the decision has been granted. (*Unwin v Bond* [2020] EWHC 1768 (Comm))

### Key lessons

- **Express duties of good faith:** The judgment is interesting in delineating minimum standards of behaviour that an express duty of good faith is likely to require.
- **Application of contractual procedural requirements:** Where an agreement contains an express duty of good faith, parties should be even more mindful of adhering to procedural requirements and following agreed processes and protocols.
- **Treatment of absolute rights:** The case is an example of an express contractual power which had been expressed as an absolute right (to terminate a party's employment) being constrained by the application of a generic contractual good faith provision elsewhere in the agreement.
- **Scope of express duty of good faith:** There may be merit in considering whether an express duty of good faith should be limited to, or excluded from, particular specified provisions.

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