**Corporate**
February 2012

CLYDE&CO

# Corporate Focus

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"A draft Financial Services Bill contained in the Government White Paper published on 16 June 2011 provides for substantial amendments to the Financial Services and Markets Act (FSMA) 2000, the Bank of England Act 1998, and the Banking Act 2009."

## The end of the FSA

**This article continues the series on financial regulatory reform that was first published in the October 2010 edition of Corporate Focus. Growing public antipathy towards the conduct of the financial services industry, together with a perception that the UK's 'light touch' regulatory regime was no longer fit for purpose, has contributed to the coalition government's decision to pursue radical change. A White Paper published on 16 June 2011 contained a draft Financial Services Bill which provides for substantial amendments to the Financial Services and Markets Act (FSMA) 2000, the Bank of England Act 1998, and the Banking Act 2009. The Financial Services Bill is currently receiving its second reading in Parliament, and is expected to be passed at the end of 2012.**

### The Financial Services Bill

Under the changes proposed, the existing 'tripartite' system of regulation which is dominated by the Financial Services Authority (**FSA**) and under which the Treasury and the Bank of England (the **Bank**) play overseeing roles, will be replaced with a system in which the Bank will have a much stronger role in protecting and enhancing the stability of the financial system of the UK. The Bank's role will be reinforced by the creation of a Financial Policy Committee (**FPC**) and the responsibility for monitoring firms will be handed to two new agencies: the Prudential Regulatory Authority (**PRA**) and the Financial Conduct Authority (**FCA**). The impact of these changes means that the FSA's days are numbered.

### Financial Policy Committee

The FPC will be a committee formed of members of the court of directors of the Bank (being directors of the Bank who are responsible for managing the affairs of the Bank, other than the formulation of monetary policy) and will be required to meet at least four times a year. Records of meetings will be published in a bid to make its workings transparent and accountable. It will be chaired by the Governor of the Bank and consist of three Deputy Governors of the Bank, two Bank executive directors, the Chief Executive of the FCA, four external members, and a non-voting Treasury representative. Through the FPC, the Bank will have responsibility for identifying imbalances, risks, and vulnerabilities in the financial services system as a whole, contributing to the Bank's financial stability objective and acting as a look out for future systemic crises. It will have primary operational responsibility for financial crisis management. According to the White Paper, it will have the power to (i) issue public pronouncements and warnings of potential crises, (ii) make

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recommendations to the Treasury, as well as having formal powers of direction over the PRA and FCA, where such powers have been granted by the Treasury. This could take the form of raising bank capital requirements, or placing loan to value limits on mortgages. The draft bill also includes a power for the Treasury to direct the Bank to provide liquidity assistance to individual financial institutions when there is a risk to public funds. The FPC's first meeting is scheduled for 16 March.

### Prudential Regulatory Authority

The PRA will be under a statutory duty to supervise firms which manage significant balance sheet risk as a core part of their business such as deposit-taking institutions, insurers, Lloyd's managing agents and larger, complex investment firms. The PRA's board will include the Governor of the Bank as chairman and the Bank Deputy Governor as chief executive. The FCA chairman will also sit on the PRA board. As a subsidiary of the Bank, its statutory objective will be financial stability. The PRA will focus on the safety and soundness of individual firms, assessing whether they are capable of conducting themselves prudently, have adequate financial resources, and whether their businesses are carried on in a fit and proper manner. To this end, the PRA's approach will be 'judgement-led', characterised by a move away from 'tick-box' compliance and an increased emphasis on forward looking risk assessment of bigger picture issues. This will consist of identifying which firms are at risk of failing and how best to respond if a firm fails. The PRA will also identify the potential systemic impact of such issues and how to resolve them, for example the impact on the economy if a firm fails and the best use of public funds in such circumstances. The nature and intensity of supervision will depend on the risks identified by senior, expert teams within the PRA.

### Financial Conduct Authority

The FCA will inherit the majority of the FSA's existing responsibilities for conduct of business regulation and the supervision of firms. It will be independent of the government and the Bank, and will have the single objective of protecting and enhancing confidence in the UK financial system. It will also play a role in securing an appropriate degree of protection for consumers and promoting effective competition in the market. It will have a specific new power to require the Office of Fair Trading to consider whether structural barriers are creating competitive inefficiencies in specific markets. In addition, the draft bill also gives the FCA a range of new tools and powers which include:

- a new power to block an imminent product launch or to stop an existing product;
- the ability to name and shame firms against which formal enforcement action has been commenced; and
- requiring firms to withdraw or amend misleading financial promotions.

### What next?

The impact of these changes means that many firms currently regulated by the FSA will in future be regulated by the PRA and FCA. It is as yet unclear how both the PRA and the FCA will work together to address issues that come under the remit of both bodies, such as the "threshold conditions" under FSMA, which are the minimum requirements that firms must meet in order to be authorised for business. A draft Order by the Treasury will clarify the ways in which both regulators should cooperate, and the new regulators will be obliged to prepare a memorandum of understanding setting out how they will coordinate the exercise of their functions. The joint publication of approach documents by the Bank and the FSA will provide further clarification of what will be expected

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of firms. What is clear is that firms regulated by the PRA and the FCA will face increased scrutiny, be subject to additional restrictions and may face adverse publicity if they do not comply with the requirements of the new regime (due to the FCA's new power to name and shame non-compliant firms). Firms should make sure that they are aware of the changes and how they are likely to impact on them.

## Breach of directors' duties

*Towers v Premier Waste Management Limited* [2011] EWCA Civ 923 serves as an important reminder to directors of the fiduciary duties owed to their companies (particularly the duty to avoid conflicts of interest) and the dangers of failing to spot situations in which they arise.

### Background

Mr Towers, formerly a director of Premier Waste Management Limited (the **Company**), enjoyed a free, undisclosed and unapproved loan of some dilapidated excavation equipment from a customer of the Company for his own personal use. The arrangement for Mr Towers to borrow the equipment was made by the Company's operations manager. Mr Towers had no direct dealing with the customer.

Despite only being used for a few months the equipment remained on Mr Towers premises for several years. Whilst the equipment was on his property, it was repaired at the cost of the Company, although this cost was later reimbursed by the customer, on the basis that he was getting back his equipment in a better condition than when he had loaned it.

The dispute arose when the customer claimed a hire charge from the Company for the period the equipment had been loaned to Mr Towers. Once the claim had been settled the Company sought to recover sums from Mr Towers on the basis that he had breached his fiduciary duties as a director of the Company.

### The Claim and the Appeal

Both the High Court and the Court of Appeal held that Mr Towers had breached his duties to the Company. Mr Towers was ordered to pay the Company a sum equivalent to the cost of hiring the equipment in the open market, together with the costs of the action. Mr Towers subsequent appeal against the decision was rejected.

### What the judgment said

In failing to seek Company approval for the loan Mr Towers was found to have breached his directors' duties of loyalty to the company (by disloyally depriving the Company of the opportunity to utilise the equipment), the duty to avoid conflicts of interest (including the duty not to make a secret profit) and the duty not to accept benefits from third parties.

The breach of duties was held to have occurred despite the fact that:

(i) the value to Mr Towers of utilising the equipment was negligible;

(ii) there was no evidence that the Company suffered a loss or would have taken the opportunity to utilise the equipment had the resource not been diverted by Mr Towers; and

(iii) there was no corrupt motive on the part of Mr Towers.

Further, the courts refused to excuse Mr Towers under section 1157 of the Companies Act 2006, which gives a court the discretion to relieve an officer (or auditor) of a company for negligence, default, breach of duty or trust if it appears to the court that that person acted honestly and reasonably in the circumstances and that they ought fairly to be excused.

It was held that in the circumstances "Mr Towers owed fiduciary duties to the Company and acted in breach of them in circumstances where there was no mitigating factor and

no evidence of injustice or hardship which might be relevant to granting relief in his favour."

### Legal implications

The case indicates that the historically strict approach to the enforcement of directors' duties, enshrined in case law, will continue to influence courts when they are determining whether a breach of duty has occurred and will inform their interpretation and implementation of the newly codified directors' duties contained in the Companies Act 2006.

### Practical advice arising from the case

When seeking to fulfil their role, directors must be alive not only to duties enshrined in the Companies Act 2006 but also to principles developed historically through case law. A breach of duty, no matter how seemingly trivial should be disclosed. Where there is any doubt regarding the happening of a breach specialist legal advice should be sought.

As Lord Justice Mummery emphasised in his judgment in the Court of Appeal; "A secret profit may be large or small; it matters not which. The vice is the fact that it is secret, undisclosed. If it was so innocent or insignificant it ought to have been and could have been disclosed."

"relying on shareholder unanimity to correct a defect in procedure is not always a safe bet, particularly when third party interests are involved."

## Shareholder and director decision making: correcting defective decisions

**A properly advised company will fulfil its legal obligations when making corporate decisions. However in many companies, decisions are made informally and are often not recorded. Whilst many everyday business decisions taken by directors and/or employees raise no questions of company law, in other cases strict legal formalities have to be observed, for example, giving correct notice of meetings and ensuring the relevant quorum is met, at board and at shareholder level. This article focuses on instances where the validity of company decisions has been challenged because legal formalities have not been complied with. As this article will illustrate, judicial response to such cases has been varied depending on who the legal formalities are considered to be there to protect.**

### Shareholder Decisions

In some companies, especially in small or family run businesses, decisions tend to be made in an informal manner and are often unrecorded. It was considered by the courts to be unfair that a lack of formality in this context should render decisions invalid so it was for this reason that the courts developed the "Duomatic" principle (deriving from a case involving a company, Duomatic Ltd). Under this principle the unanimous assent of shareholders has overriding authority and therefore is able to validate decisions made where the proper procedures have not been followed. There is no need for the shareholders to have given their agreement at the same time or place, or even in writing. Whilst the principle has not been codified in any legislation, it has been preserved by the Companies Act 2006 (the **Act**). Under the Act unanimous consent of shareholders can still be used to ratify the acts of directors.

The Duomatic principle has received mixed judicial treatment. The contrasting cases Re *RW Peak (Kings Lynn) Ltd* and *Wright v Atlas Wright*, decided within a year of each other, are examples of this.

### Re RW Peak (Kings Lynn) Ltd [1998] B.C.C. 596

In Re *RW Peak* the validity of a buy-back of shares was challenged on the grounds that statutory procedure had not been complied with. The court held that complying with statute was not merely a technical exercise and stated that as the statutory buy-back

"A majority vote will not validate every procedural deficiency."

provisions protect third party interests it would be inappropriate to allow shareholders to waive these third party rights.

### Wright v Atlas Wright [1999] B.C.C. 163

In *Wright v Atlas Wright* the court considered the Duomatic principle in the context of shareholder approval for directors' long-term service contracts. As in Re RW Peak, the court looked at the purpose of the statutory provision in question in determining whether the principle should apply. In this case the court found that the purpose of the relevant provision was to protect the interests of the shareholders only. As such the principle rescued the transaction.

The approach in *Wright v Atlas Wright* was subsequently adopted in *BDG Roof-Bond Ltd v Douglas [2000] B.C.C. 770* in which it was held that the statutory requirement for a special resolution in these circumstances was "designed solely for the benefit of shareholders" and so the Duomatic principle applied to validate the share buy-back, despite not all the statutory procedures being complied with. Indeed the judge in this case deemed the lack of availability of the buy-back contract at the registered office in advance of its approval, which was required by statute, a "pointless formality in the circumstances".

There is a clear distinction in the courts' reasoning in these cases. In *Wright v Atlas Wright* and *BDG Roof-Bond Ltd v Douglas* the procedure in question was designed to protect the interests of shareholders only and so the courts ruled that a unanimous decision by those persons could override procedure. This contrasts with the decision in Re *RW Peak* where the procedure protected third party interests and so it would have been unfair to allow the shareholders to override this third party protection by using the Duomatic principle.

### Director Decisions

Although the Duomatic principle is normally cited in the context of members' decisions, it is generally accepted that a similar rule applies to director decisions. Anything the directors can do at a formal board meeting they can do informally if they all agree to it. This principle in practice is often watered down, with some directors believing that a majority rather than unanimity is enough to override procedure. A recent case however has demonstrated the impact that side stepping formalities can have on the enforceability of directors' decisions.

In *Minmar (929) Ltd v Khalatschi [2011] B.C.C. 485*, a company director successfully argued for an order to set aside the appointment of an administrator on the grounds that the formalities set out in the company's articles had not been complied with.

The dissenting director applied for the order on the grounds that there had not been a properly convened meeting of the directors to appoint the administrator, as required by the company's articles of association. He also argued that no notice had been served on the company in accordance with the Insolvency Rules.

The other directors argued that the need for a formal meeting had been dispensed with because they represented a majority of the board.

The court held that this did not validate an act made in breach of a company's articles of association. The appointing directors had not held a valid meeting of the board in accordance with the articles and the appointment was therefore invalid and should be set aside.

This judgment makes it clear that adherence to the formalities prescribed in the company's articles of association is required, otherwise the decision in question could be declared invalid.

"Commercial organisations operating across a number of jurisdictions often implement a single whistleblowing policy however the usefulness and implementation of such policies may prove problematic in certain jurisdictions."

### Conclusion

It is important to ensure that companies follow the correct formalities when making certain corporate decisions. Case law clearly shows that relying on shareholder unanimity to correct a defect in procedure is not always a safe bet, particularly when third party interests are involved. In light of the Minmar case directors also need to be mindful of formalities as a majority vote will not validate every procedural deficiency. After all, the fact that many of the procedural formalities which existed under the previous Companies Act still remain under the Act indicates that formal procedures are still considered to have significant worth. The most effective way to ensure a corporate decision is free from challenge is to follow all procedures and seek legal advice when in doubt.

## Whistleblowing

**In the previous edition of Corporate Focus we reported that the Bribery Act 2010 (the Bribery Act) came into force on 1 July 2011 and we considered procedures that commercial organisations could put into place in order to prevent bribery. In this article we consider: (1) key issues that a commercial organisation operating across a number of jurisdictions should be aware of in relation to the implementation of a whistleblowing policy as part of its anti-bribery policy; and (2) frameworks that are in place to encourage whistleblowers to come forward.**

### What is whistleblowing?

Whistleblowing is when an individual in a commercial organisation reports on wrongdoing in his or her organisation. Certain statutory protections are afforded to whistleblowers which protect them from losing their jobs and/or being victimised.

### The Bribery Act 2010

According to section 7 of the Bribery Act it is an offence for a commercial organisation to fail to prevent bribery on its behalf by a person associated with it. A commercial organisation prosecuted under section 7 can, according to section 7(2) of the Bribery Act, raise the defence of having adequate procedures in place to prevent bribery.

What will be adequate depends on the commercial organisation itself. Guidance from the Ministry of Justice (the **MOJ**) explains that such procedures must be proportional, considering the nature and the scale of the business undertaken by the commercial organisation and should further be clear, practical, accessible, effectively implemented and enforced. Typically, such procedures will comprise of anti-bribery policies and staff codes of conduct dealing with, amongst other things, whistleblowing. No policies or procedures however are capable of detecting and preventing all bribery.

### Whistleblowing Policies

Whilst in the UK it is for a commercial organisation itself to decide on whether a whistleblowing policy is required, in some jurisdictions such as the USA, public companies are required to have whistleblowing procedures in place.

Commercial organisations operating across a number of jurisdictions often implement a single whistleblowing policy however the usefulness and implementation of such policies may prove problematic in certain jurisdictions. In particular:

- Commercial organisations being prosecuted for a violation of the US Foreign Corrupt Practices Act 1977 (the **FCPA**) will not be able to use adequate procedures as a defence. They will however be able to use such policies as evidence of the organisation's good faith which prosecutors in the US may take into account when deciding what action to take against the commercial organisation; and

"The potentially serious consequences that would follow a discovery of bribery if it was not self-reported together with increasing levels of cooperation between the US and UK authorities may lead to an increase in self-reporting in the UK by commercial organisations and particularly those that are subject to the jurisdiction of both UK and US bribery laws."

– Commercial organisations which have established whistleblowing hotlines as part of their whistleblowing policies in order to comply with their obligations under the US Sarbanes-Oxley Act of 2002 need to be aware that such hotlines may conflict with EU data protection and privacy laws.

In the EU, in order for any data by which a person can be identified to be legitimately processed it must have been collected fairly and lawfully. According to the EU Data Protection Directive (Directive 95/46/EC) processing of such data must be necessary for compliance with a legal obligation and/or must be necessary for the purposes of legitimate interests pursued by the commercial organisation collecting the data. In general, the EU does not recognise the need to comply with the Sarbanes-Oxley Act as amounting to a legal obligation but the need to prevent financial irregularity could be considered to be a legitimate interest. Accordingly, if a commercial organisation should adopt a whistleblowing hotline, the approach taken in the EU is that adequate data protection safeguards ought to be built into the whistleblowing policy including, amongst other things, to:

– encourage confidential named reporting rather than anonymous reporting;
– ensure the safeguarding of information collected;
– ensure that information collected in the EU is retained within the EU;
– ensure that information is not retained for any longer than is necessary; and
– ensure that any employee who is the subject of a whistleblower's allegations is given the right to answer the allegations.

Whistleblowing policies that are intended to apply across a number of jurisdictions should take into account the requirements of the jurisdictions in which a commercial organisation operates. Commercial organisations should seek specific local legal advice on compliance with local laws and regulatory requirements.

## Encouraging whistleblowers to come forward

Incentives for whistleblowers in the US may lead to an increase in whistleblowing which in turn may lead to more companies self-reporting in order to try to avoid more severe consequences that may result from not having done so.

There are no provisions in the Bribery Act regarding incentives or rewards for whistleblowers. If however a whistleblower is involved in bribery himself but agrees to assist the Serious Fraud Office (the **SFO**) with its investigation the whistleblower may be granted immunity from prosecution or if the whistleblower is convicted of an offence, assisting the SFO with other investigations may make the whistleblower eligible for a reduced sentence. Recently however the UK courts have emphasised that sentencing is a matter for the courts and the SFO can only recommend a sentencing range.

In the US the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the **Dodd Frank Act**) incentivises whistleblowing in relation to securities law violations by offering whistleblowers a share of the funds recovered by the state and also providing them with a cause of action against their employers if they are the subject of victimisation.

It is thought that the potentially serious consequences that would follow a discovery of bribery if it was not self-reported together with increasing levels of cooperation between the US and UK authorities may lead to an increase in self-reporting in the UK by commercial organisations and particularly those that are subject to the jurisdiction of both UK and US bribery laws to avoid the danger of a whistleblower reporting wrongdoing in the US and subsequently being investigated by the authorities in the UK.

"The purpose of a Statutory Residence Test would be to provide greater certainty which, it is believed, should increase the attractiveness of the UK to potential overseas investors."

"The Statutory Residence Test will fall into three parts; Part A will contain conclusive non-residence factors, Part B will contain conclusive residence factors, and Part C will contain other connection factors and day counting rules that will only need to be considered by those whose residence status is not determined by Part A or Part B."

# The Proposed Statutory Residence Test for Individuals

**HMRC published a consultation document proposing a statutory residence test (SRT) on 17 June 2011.**

The residence status of individuals, which is crucial to determining liability to UK tax has, for many years, been governed by rather dated case law together with the pronouncements of HMRC in leaflet IR20 (recently replaced by HMRC6). Recent litigation, such as that in the *Gaines-Cooper* case has demonstrated that elements of IR20 have been viewed in different ways by HMRC on the one hand and taxpayers and their advisers on the other, and that the current rules can be very hard to apply in practice.

The purpose of an SRT would be to provide greater certainty which, it is believed, should increase the attractiveness of the UK to potential overseas investors.

Paragraph 1.7 of the consultation document states:

"The Government is…committed to introducing a statutory test that is transparent, objective and simple to use."

Consultation closed in September 2011 and the original intention was that the final legislation should be contained in Finance Bill 2012. In December 2011 it was announced that due to the detailed issues raised in responses to the consultation the Government had decided that it would legislate the SRT in Finance Bill 2013 to take effect from April 2013, rather than April 2012.

This article is based upon the proposals contained in the consultation document and, given the protracted nature of the process, it should be noted that the final legislation, assuming that it is enacted in Finance Act 2013, may well be different. It will be essential, of course, to take advice based upon the legislation as actually enacted.

## How the SRT will work

The SRT will fall into three parts; Part A will contain conclusive non-residence factors, Part B will contain conclusive residence factors, and Part C will contain other connection factors and day counting rules that will only need to be considered by those whose residence status is not determined by Part A or Part B.

Part A of the test will conclusively determine that an individual is not resident in the UK for a tax year if they fall under any of the following conditions:

- were not resident in the UK in all of the previous three tax years and they are present in the UK for fewer than 45 days in the current tax year;
- were resident in the UK in one or more of the previous three tax years and they are present in the UK for fewer than 10 days in the current tax year; or
- leave the UK to carry out full-time work abroad, provided they are present in the UK for fewer than 90 days in the tax year and no more than 20 days are spent working in the UK in the tax year.

Provided that Part A of the SRT does not apply, an individual will be conclusively resident under Part B if they meet any of the following conditions:

- are present in the UK for 183 days or more in a tax year;
- have only one home and that home is in the UK (or have two or more homes and all of these are in the UK); or
- carry out full-time work in the UK.

In the unlikely event that both Part A and Part B are satisfied for a particular year, for example, if an individual only has one home which is in the UK but spends very few days in the UK, then Part A will take precedence and the individual will not be resident in the UK in that year.

Part C would only apply to those individuals whose status was not determined by Parts A or B. Under Part C an individual would need to compare the number of days they spend in the UK against a number of "connection factors".

The connection factors are:

1. Family in the UK
2. Accommodation in the UK
3. Substantive work in the UK
4. UK presence in previous year
5. More time in the UK than in other countries

The connection factors would be combined with days spent in the UK into a "scale" to determine whether or not an individual is resident. The suggestion is that there should be separate scales for arrivers and leavers to reflect the Government's view that it should be harder for leavers to relinquish residence.

If an individual was not resident in all of the three tax years preceding the year under consideration then in broad terms connection factors 1 to 4 above may be relevant to their residence status.

The way in which the connection factors would be combined with days spent in the UK would be as follows:

| Days in UK | Impact of connection factors |
|---|---|
| Fewer than 45 days | Always non-resident |
| 45 – 89 days | Resident if 4 factors |
| 90 – 119 days | Resident if 3 factors or more |
| 120 – 182 days | Resident if 2 factors or more |
| 183 days or more | Always resident |

If the individual was resident in one or more of the three tax years immediately preceding the tax year under consideration then all five of the connection factors come into play with the following results:

| Days in UK | Impact of connection factors |
|---|---|
| Fewer than 10 days | Always non-resident |
| 10 – 44 days | Resident if 4 factors or more |
| 45 – 89 days | Resident if 3 factors or more |
| 90 – 119 days | Resident if 2 factors or more |
| 120 – 182 days | Resident if 1 factor or more |
| 183 days or more | Always resident |

## Other issues

It is proposed that split year treatment should continue to be available in certain circumstances.

It is also proposed that anti-avoidance provisions should be introduced; the key objective appears to be to deter individuals from becoming non-resident for short periods in order to avoid a liability to UK tax on expected income.

## Conclusion

The proposed SRT appears to be an improvement on the current position which has complex and somewhat uncertain rules. It is to be hoped that once things settle down it will be relatively simple to apply the tests and that clarity will be available in most cases.

**Further information**
If you would like further information on any issue raised in this newsletter please contact:

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Further advice should be taken before relying on the contents of this summary.



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