



Quarter in law

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A guide for busy directors and company secretaries. Out now!...[click here](#)

HMRC lose key High Court *Vodafone* case

HMRC has been successful in cases which do not involve EU law, but it has been less fortunate with cases on EU matters.

Judgment has been given in the High Court in favour of the taxpayer in the case *Vodafone 2 v HMRC*. The High Court decided that UK legislation relating to controlled foreign companies (CFC), under which UK companies owning shares in such a company, can be assessed for tax in respect of the profits of the CFC, was incompatible with EU law.

The earlier case of *Cadbury Schweppes plc & Another v Inland Revenue Commissioners* had already established that the CFC legislation could only be applied to ‘wholly artificial arrangements’. In response to this, new legislation was included in Finance Act (FA) 2007 (Section 48, schedule 15), with the intention that the CFC legislation, as amended, should now be compliant with EU law. The new legislation applied from 6 December 2006, but question marks still exist as to whether the CFC legislation remains non-compliant, even when taking these changes into account.

The *Vodafone 2* decision, which relates to periods before 6 December 2006, goes further than the *Cadbury Schweppes* case. Vodafone argued that the CFC legislation was incompatible with the provisions of EU Articles 43 and 48 (which deal with the ‘right to freedom of establishment’) and therefore no charge could be imposed under it.

Mr Justice Evans-Lombe agreed. In a carefully worded decision, in which he quoted Lord Walker in the case of *Fleming v HMRC*, he held that the CFC legislation should be disapplied because of its inconsistency with EU law. He held that the Courts should attempt to avoid any inconsistency between national legislation and EU law by interpreting the former to conform with the latter if at all possible. He held that it was impossible for him to interpret the CFC legislation in a way which was compliant with EU law and therefore disapplied it.

Assuming the decision is not overturned on appeal, there are a number of situations where companies should resist requests to supply information regarding CFCs. More importantly there may be opportunities to reclaim tax already paid for periods before 6 December 2006:

- amendment of existing returns where time limits permit;
- claims for relief for tax overpaid under the provisions relating to mistakes in a tax return; and
- claims for damages under common law in respect of tax paid in error.

For periods from 6 December 2006, HMRC will argue that the amendments made by FA 2007 will have the effect that the CFC legislation is no longer contrary to EU law. This is a point of some doubt, and companies will also wish to consider whether they can also claim that tax under the CFC legislation should not be paid for all periods.

There are other parts of the UK legislation which, based on the principles reinforced by *Vodafone 2*, are also considered to be incompatible with the EU law and may enable companies to reclaim additional tax that has been paid as a result of the application of these provisions. In particular, the time limits for claims for VAT repayments are now established following the *Fleming* and *Conde Nast* judgments, and urgent action is now needed to quantify and make such claims.

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Stamp duty land tax – five years and counting



The stamp duty land tax (SDLT) regime came into force on 1 December 2003. Almost five years on, many leases entered into under the new regime are approaching rent reviews. What does this mean for tenants?

Under the SDLT regime, tax is charged on the net present value of rent charged under the lease for the term of the lease. Where the rent is unknown at the start of the lease, the value is calculated based on an estimate of the rent, and a land transaction return (LTR) is submitted to HMRC along with payment.

Once any unknown rental amounts are determined there may be a requirement for a further LTR to be submitted to HMRC. Any additional tax will then need to be paid, along with interest on that amount.

If the rent for the first five years of the lease was ascertained at the start of the lease, and if a rent review is carried out in the fifth, or any subsequent year of the term, a further LTR is only necessary if there is an increase of rent of more than 20%.

However, there are more onerous obligations on tenants where the rent is reviewed or there is some other variation (for example, due to turnover rent provisions) within the first five years of the term. In these instances, once the rent of the first five years becomes certain, there needs to be a recalculation of SDLT using the actual rent figures. A LTR will need to be submitted to HMRC if more SDLT is payable or if the transaction now exceeds the minimum threshold for payment of SDLT.

Conversely, any overpayment of SDLT will be refunded by HMRC upon a claim made by a tenant.

It is prudent for tenants to review their leases upon a rent review or determination of unknown rent amounts, and ensure that any additional payments of SDLT are made to HMRC. Failure to do so will incur penalties and interest charges.

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A chill in the air? Important reminder: air-conditioning inspections due 4 January 2009

Building owners and managers who control air-conditioning systems have a statutory duty to have the systems inspected. All systems with an effective output of more than 12kW will eventually need to be inspected at least once every five years by an energy assessor. These obligations are set out in the Energy Performance of Buildings (Certificates and Inspections) (England and Wales) Regulations 2007.

The obligation is to be implemented on a rolling basis. Air-conditioning systems with an output of over 250kW must be inspected by 4 January 2009 and those with an output of 12kW are to be inspected by 4 January 2011, and thereafter at least once every five years. Any new system installed on or after 1 January 2008, must have an inspection within the first five years of being put into service.

The penalty for failing to have an air-conditioning inspection report is currently £300.

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Capital reductions: a new regime for private limited companies

From 1 October 2008, the new solvency statement procedure for private limited companies wishing to undertake a capital reduction became effective. The new regime is part of the wider ambit of the Companies Act 2006 to reduce procedures and administrative burdens for private limited companies.

The Companies Act 2006 sees the overhaul of the capital reduction regime for private limited companies. The three principal changes under the Act are:

- 1) the introduction of the new solvency statement procedure for private limited companies as an alternative to the Court approved capital reduction procedure;
- 2) a company no longer has to have specific authorisation in its articles of association permitting it to reduce its capital; however, there may be a specific prohibition contained in the articles; and

- 3) when a company notifies the Registrar of a reduction of its capital (Court approved or via solvency statement), the documents filed to allow the reduction to become effective must include a statement of capital, setting out the details of the company's share capital as reduced. Ultimately this will be in a prescribed Companies House form. However, there are transitional arrangements for a period from
- 4) 1 October 2008, allowing a memorandum to be filed showing the company's share capital as reduced at the time of registration.

From October 2008, private limited companies have two alternative routes to choose from should they wish to undergo a capital reduction. Firstly, the traditional Companies Act 1985 Court approved procedure which largely remains the same under the 2006 Act, and secondly, the new solvency statement procedure as prescribed by the 2006 Act.

The intention of the new solvency statement is to create a streamlined capital reduction procedure which is cost effective for private companies. There is a greater risk to directors using the solvency statement process as there is more potential for the

process and the due diligence to identify liabilities to be questioned (for example, in a future due diligence process) as the independent scrutiny by the Court will be absent. On the other hand, a Court approved reduction offers the directors more protection from liability as the Court sanctions the reduction. The Act makes it a criminal offence to make a solvency statement without having reasonable grounds for the opinion expressed in it which is then delivered to the Registrar. Directors therefore need to ensure the necessary due diligence has been undertaken to ensure the Company's solvency. Some directors may wish to engage an independent adviser to confirm the director's opinion set out in the solvency statement is reasonable.

The Act states that reserve arising from any reduction of capital is not distributable, subject to any order made by the Secretary of State. The Companies (Reductions of Share Capital) Order 2008 states that the prohibition does not apply (i.e. the reserves will be distributable) if an unlimited company reduces its share capital, if a reduction of capital is confirmed by the Court, or if a private limited company carries out a reduction of capital supported by a solvency statement, but does not apply to the Court

for an order confirming the reduction. If a company reduces its share capital via a Court approved reduction the reserve is treated as a realised profit unless the Court orders otherwise.

Private limited companies now have an alternative capital reduction process which is no longer tied to and driven by a strict and sometimes lengthy Court timetable. In theory, the solvency statement process can be carried out within a week, depending on the nature and history of the company and what financial information/due diligence needs to be undertaken to support the solvency statement.

Since 1 October 2008, private limited companies now have the option to undergo a capital reduction via the new streamlined solvency statement regime. The new regime will be welcomed by non-trading holding companies wishing to reduce their capital as the new process can be finalised within a week.

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Hot topic: data protection moves up the agenda

Recent high-profile reports on data protection and proposed amendments to privacy laws could have a big impact on how organisations manage their handling of personal data and the potential penalties if sufficient controls are not implemented.

Data sharing review

In July 2008, the Information Commissioner, Richard Thomas, and Mark Walport, director of the Wellcome Trust, published a report on data sharing and data protection, following a review commissioned by the UK Government in 2007.

The report includes recommendations for transforming culture in the use of personal data and developing the role of the Information Commissioner's Office (ICO). The recommendations include the following.

Penalties for non-compliance

- The ICO's new powers to fine organisations for serious breaches of the Data Protection Act 1998 (see summer 2008 edition of *Quarter in Law*) should mirror the sanctions available to the Financial Services Authority (FSA), setting high but proportionate maximum penalties. This could substantially increase the risks associated with data protection breaches across all industries – recent fines by the FSA for failures in data security controls (e.g. imposed on the Nationwide Building Society and Norwich Union) have been in the region of £1m. Regulations setting out maximum fines which can be imposed by the ICO are expected later this year.

- The ICO should have the power to carry out an inspection of premises with co-operation from the relevant organisation. In August 2008, the Ministry of Justice published a report building on this recommendation and proposing additional ICO powers of inspection and access to information relating to data protection compliance.

Good practice in data protection compliance

- Organisations handling significant amounts of personal data should identify where data protection ownership and accountability lies, as part of their corporate governance arrangements.
- Companies should review their internal controls over the use of personal data, at least annually, and this should be reported to shareholders.
- Transparency in the use of personal data should be increased, including the prominence and scope of privacy policies and information provided to individuals.
- Staff training on data handling should be reviewed and enhanced.
- Organisations should avoid unnecessary collection of personal data by considering authentication (e.g. collecting credentials showing an individual meets a particular standard), as an alternative to identification (e.g. collecting name and identifying details).
- Significant data breaches should be notified to the ICO.



...cont'd

Hot topic: data protection moves up the agenda - cont'd

Additional reports

Other recent reports focus on the use of personal data in the public sector, including:

- a report in June 2008 by Kieran Poynter of PricewaterhouseCoopers LLP on information security, following a data breach by HMRC; and
- a report by the Cabinet Office in June 2008 proposing clear common data handling standards and procedures for Government departments.

Changes to European data protection laws

The ICO is leading a review into the reform and modernisation of European data protection laws and has commissioned an assessment of the strengths and weaknesses of the current regime.

In addition, a proposed new EU regulation will amend current privacy laws associated with electronic communications. Under the draft regulation, serious security breaches in a communications service would need to be notified to the subscribers of that service. If this is adopted, it will be the first piece of UK legislation requiring customers to be notified of data security breaches. Such notification requirements have already become widespread in the US. The final regulation is expected later this year.

What now?

As the above recommendations and proposals develop, there are likely to be substantial changes to expected standards of data protection compliance and legal sanctions available to the ICO. It is clear that data protection is currently high on the Government's agenda and organisations should be moving it up theirs as well.

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Taking market abuse and insider dealing more seriously

On 1 August 2008, the FSA announced the conclusion of its investigation into potential market abuse during trading in HBOS shares. In March 2008, with press speculation mounting as to the state of the UK banking system and potential bank failures, HBOS shares experienced a price fall amid market speculation to the effect that HBOS faced liquidity problems. Following statements by HBOS, the Bank of England and the FSA denying the rumours, the FSA warned market participants against taking advantage of market conditions to commit market abuse by spreading false rumours and dealing on the back of them. At the same time, the FSA launched an investigation to determine whether the movements in HBOS' share price was attributable to short sellers seeking to make a profit on the back of deliberate spreading of false rumours.

Having analysed trading records and data, contacted and interviewed various market participants and news organisations, reviewed emails, as well as message boards and press coverage of the period, the FSA reported in August that it had found no evidence to support the view that rumours had been spread as a part of a concerted attempt by some individuals to profit by manipulating the HBOS share price. The FSA found that although false and damaging rumours had been in circulation and these would inevitably have impacted on the HBOS share price, other complex factors were also at play, the interaction of which would also have impacted on the share price.

Despite the results of the HBOS investigation, the FSA emphasised it would continue to react quickly to investigate potential market abuse. The FSA warned market participants to expect surveillance and investigation activity to continue at a high level of intensity and reinforced the message that where it appears firms have benefited following false or misleading rumours, the FSA will require firms/ individuals to provide immediate access to traders, information and trading strategies as well as email, messaging and telephone records.

Recent press reports highlighting FSA investigations and arrests for alleged insider dealing further indicate the robust approach being pursued by the FSA. In a speech in June 2008, Margaret Cole, director of enforcement at the FSA, stated the organisation had brought three criminal prosecutions for insider dealing this year with more in the pipeline. Ms Cole remarked that the FSA wants to effect a real change in behaviour and wants to see the City taking market abuse more seriously. She intends the FSA to be bolder and more resolute in proceeding with market abuse and insider dealing cases.

At the same time as announcing the results of the HBOS investigation, the FSA announced the launch of a review by the Markets Division of firms' systems and controls for dealing with rumours. Covering investment banks, securities firms and hedge fund managers, the FSA will examine the policies firms have in place and how they ensure compliance, whether and how rumours are verified, whether traders are permitted to pass on or trade on rumours, and how firms ensure staff do not initiate or spread false rumours. The FSA expects to report its findings in the autumn.

Meanwhile, an industry working group (facilitated and supported by the FSA but not constituting FSA guidance) has issued guidance to raise awareness in the non-regulated community of good practice for handling inside information. The working group's principles of good practice contain six principles together with examples of good practice. These cover policies and procedures; awareness and training; 'need to know' and other information controls; passing price sensitive information to third parties; information technology security; and personal dealing policies. The full text is appended to issue 27 of *Market Watch* available on the FSA's web site.

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Private equity firms – good practice managing conflicts of interest

The FSA recently reported the results of its latest thematic review of the management of conflicts of interest (COI) within private equity firms. Focusing on regulated firms operating in the private equity business, the main objective of the review was to inform the FSA and external stakeholders of current standards within the regulatory community. For the FSA, the review also provides an opportunity to promote COI good practice within the industry generally.

On a positive note, the FSA found that most firms visited were maintaining a broadly adequate approach to conflict management. Use of formal conflict management programmes has not, however, been adopted by all firms, with fewer than 80% of those surveyed maintaining formal conflict policies and procedures and only 70% of those policies receiving regular formal review. In general, the FSA's findings suggest firms are relying primarily on the investment process and fund documentation to address potential conflicts of interest, and there is an over-reliance on the reputation and culture of the firm as a means of influencing staff behaviour.

The FSA identified areas such as investment allocation, preferential terms and financial incentives as those most likely to give rise to potentially material conflicts. The latter include:

- conflicts between investors in separate funds operated by the same fund manager, e.g. in relation to the allocation of investment opportunities, the timing for the divestment of joint holdings or the transfer of assets between funds;
- conflicts arising where the firm or affiliated parties are permitted to co-invest in private equity

transactions alongside the fund on a deal by deal basis on preferential terms (allowing over or under investment) to those offered to the fund's third party investors; and

- conflicts arising where private equity firms receive financial incentives from structuring private equity transactions (as a result of managing the fund) which are not rebated back to the fund or clearly disclosed to fund investors.

Although by and large, firms visited during the review are actively managing the risks associated with such conflicts, the FSA notes scope exists for firms to further bolster and formalise conflict management procedures. It notes that good practice tends to exist where there is formalised conflict management with processes and procedures engendering senior management and staff buy-in. Examples of good practice include:

- use of annual compliance declarations requiring staff to personally confirm knowledge of a firm's COI policy and adherence to associated codes of conduct;
- proactive deal by deal disclosure of actual conflict issues to all fund investors via distribution of the investment committee and the investor advisory committee minutes;
- the use of separate and distinct committee structures to ensure appropriate review of potential conflict areas, e.g. allocation of investments between funds controlled by the allocation and investment committee; staff co-investment reviewed by the remuneration committee; and valuations committee to review fair valuations of illiquid securities;

- regular and proactive monitoring mechanisms, e.g. a 'live' risk map, specific ad hoc compliance monitoring;
- use of deal conflict check-lists at entry and exit of investments to document apparent conflicts, methods of management and firm sign-off; and
- use of formalised business line mandates and allocation policies detailing the basis on which investment opportunities are allocated between funds, the firm and other co-investors.

The FSA suggests firms wishing to benchmark their COI performance against the findings of the thematic review might focus on some of the following areas:

- suitable staff training programmes;
- development of formal policies and procedures to clarify the firm's approach to business areas likely to give rise to potential conflicts on a recurring basis;
- appropriate use of proactive compliance measures to ensure ongoing monitoring of the business;
- ensuring adequate COI disclosure to investors; and
- ensuring the firm's approach to conflict management is compliant with systems and controls, SYSC 10 common platform requirements.

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Proposed reform of limited partnership law

The Department for Business Enterprises & Regulatory Reform (BERR) has published a consultation paper in relation to certain proposals to modernise and simplify the law on limited partnerships. It is proposed that the Limited Partnerships Act 1907 be repealed and new provisions about limited partnerships inserted into the Partnership Act 1890. The deadline for responses to the consultation is 21 November 2008. Subject to the outcome, it is proposed that the changes be implemented from 1 October 2009.

The proposed reforms

The proposed reforms do not affect the general nature of limited partnerships, but include clarifications of uncertainties that have arisen since the Limited Partnerships Act 1907 was implemented.

One of the key features of a limited partnership is that a limited partner's liability is limited to their capital contribution provided that they take no part in the management of the partnership. There are several significant proposals in this area.

- It is proposed that a list of activities be adopted, detailing the activities limited partners are able to undertake without losing their limited liability. The list includes (but is not limited to):
 - taking part in decisions about the variation of the partnership agreement, whether to approve or veto an investment by the partnership, and whether the partnership should end or be wound up;
 - approving the partnership's accounts;

- discussing the prospects of the partnership business;
- acting as a director or employee of, or shareholder in, a corporate general partner; and
- consulting or advising a general partner about the activities of the limited partnership or its accounts (including doing so as a member of an advisory committee of the limited partnership);
- limited partners will no longer be obliged to make any capital contribution to join the partnership (though they may make a capital contribution if they wish); and
- a limited partner may withdraw capital, subject to agreement between the partners, and the limited partner will remain liable for the debts and liabilities of the partnership up to the amount of capital withdrawn until 12 months after the date of registration of the withdrawal at Companies House. This is a change from the current law which prohibits any withdrawal of a limited partner's capital contribution and provides that if capital is withdrawn the partner should be liable indefinitely for the debts and liabilities of the partnership, up to the amount of capital withdrawn.

In addition to the above, the proposed reforms clarify the date on which a limited partnership comes into existence, and the point from which a limited partner gains limited liability. It does this by making the date of registration of a limited partnership the operative date and providing that the registrar's certificate is conclusive, notwithstanding any errors in registration formalities.

Minor clarifications to the law on the rights and obligations of partners in a limited partnership are also proposed. For example, the proposed reforms clarify that a limited partner will not owe certain statutory duties which a normal partner owes – for instance, they will not have to account to the other partners for profits made elsewhere.

Impact on UK investment funds industry

Limited partnerships are used widely in the UK, Europe and the United States for venture capital, real estate and private equity investment funds. While the UK has been the preferred jurisdiction for fund managers investing in Europe, BERR acknowledges that investment managers are increasingly 'jurisdiction shopping' when deciding where to establish investment funds. It is therefore important for the UK Government to ensure that the UK legislative framework continues to facilitate the use of limited partnerships as attractive investment fund vehicles. The proposals to reform the limited partnerships regime are intended to achieve this by increasing clarity and certainty and removing unnecessary burdens.

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A Practical Guide to the Companies Act 2006 - A guide for busy directors and company secretaries.

The Companies Act 2006 is the most significant reform of company law for over 20 years. It applies to all companies carrying out business in the UK and assessing its implications is a daunting task. *A Practical Guide to the Companies Act 2006* gives clear and practical guidance on the updated Act for everyday situations of relevance to directors, in-house counsel and company secretaries.

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