

4.4

Legal Aspects of a Company Flotation

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Introduction

This chapter primarily deals with the procedure and the involvement of legal advisers for a UK company seeking a listing for its shares on the official list of the London Stock Exchange plc.

It should be noted that in addition to the main list of the Stock Exchange, there are various other public markets on which a company may seek to have its shares admitted to trading.

Those markets include the Alternative Investment Market of the Stock Exchange (AIM, the successor to the Unlisted Securities Market) and OFEX. OFEX was established in 1985 to provide a share-trading platform for unlisted and unquoted securities. While OFEX is not a recognised investment exchange, its objectives are akin to those of AIM and the main market of the Stock Exchange in that it provides a market for companies to have a public method of trading their shares. The majority of the principles and the role of the company's solicitors in a flotation process will apply to each of these three markets, although naturally there are variances between the three.

The decision to seek a public listing is undoubtedly a major landmark in the development of any company. A listing will be

thought likely to dramatically enhance the company's reputation and profile and may well generate substantial capital to fund the expansion of the company. One must, however, appreciate the challenging nature of a public listing and the time commitment that this involves for the directors. The marketing of a public company's securities is strictly regulated in order to afford as much protection as practicable to potential investors. The bulk of this regulation is set out in the Financial Services Authority's listing rules commonly known as 'the Yellow Book', although the colour of that book is now in fact purple! In addition to the listing rules, one must pay particular attention to the provisions of the Financial Services Act 1986 (FSA), the Financial Services and Markets Act 2000 (FSMA) and the Public Offers of Securities Regulations 1995 ('the POS Regulations').

Legal due diligence and pre-float grooming

One of the early tasks of the company's solicitors will be to undertake a thorough legal due diligence exercise into the company. This process will inevitably involve a large amount of management time as solicitors seek to establish and review the constitutional/contractual position of the company. Matters will include:

- review of the company's memorandum and articles of association;
- establishing directors and current shareholders;
- establishing employees and their contractual terms of employment including benefits, pension schemes, life assurance etc;
- details of any subsidiary, associated or other group companies;
- the company's banking relationship and any security provided to its financiers;
- intellectual property rights owned or utilised by the company and the establishment of valid licensing agreements relating to the same;
- principal trading relationships with both the company's suppliers and customers and the proper regulation of those by means of carefully drafted contractual agreements providing sufficient protection to the company;
- any litigation with which the company is involved;
- property owned or occupied by the company;
- environmental issues affecting the company and licensing requirements.

Once the company's solicitors have obtained this information, they will then produce a detailed due diligence report. Contained within the report are likely to be a series of recommendations for further 'legal grooming', for example properly documenting the company's relationship with its suppliers and customers/preparation or revision of employment contracts and quite possibly a requirement for reorganisation of the company, if part of a group, prior to flotation. It is perhaps self-evident but worth noting, however, that a company seeking to offer its shares to the public will need to have the status of a public limited company rather than a private limited company. The requirements for a public limited company include an issued share capital of no less than £50,000, which must be at least one-quarter paid up. It may therefore be necessary to re-register the private company as a public company prior to flotation. It is also usual to reorganise the company's capital structure to create sufficient share capital to ensure that any shares to be issued can be offered at a price that the market will find attractive. New long-form articles of association are generally adopted which will need to be CREST-compliant and also to ensure that shares are freely transferable and do not contain any form of transfer pre-emption rights. CREST is the paperless settlement system that provides electronic book entry transfer of registered stock.

Company prospectus/listing particulars

The principal document produced as part of the flotation process will be the prospectus or listing particulars. This is the document which is made public and is intended to provide a potential investor with sufficient information upon which to base a decision to invest. While the directors often initially view this document as a sales document, it is the document which presents the greatest risk to the directors if the content is inaccurate or misleading. The prospectus will cover the following issues:

- the persons responsible for listing particulars, namely the directors, the company and the auditors;
- the shares for which the application is being made;
- the issuer and its capital;
- the group's activities;
- the issuer's assets and liabilities, financial position and profits and losses;

- the management team;
- recent developments and prospects of the group.

The legal advisers will play an active role in the drafting and preparation of the prospectus and, in particular, the statutory and general information section dealing with the company, the terms of its memorandum and articles of association, the directors and their interests in the company, the terms of directors' service agreements and emoluments, the company's working capital, share option schemes in place or to be put in place by the company, the company's property interests, any litigation with which the company is involved, material contracts (outside the ordinary course of business) involving the company and taxation.

The persons responsible for the prospectus include the company and the directors personally. This includes a general duty of disclosure in addition to requirements in respect of the contents of the prospectus. In order to satisfy this general duty, the prospectus must contain all such information as investors and their professional advisers would reasonably require, and reasonably expect to find, for the purpose of making an informed assessment of:

- (a) the assets and liabilities, financial position, profits and losses and prospects of the issue of the securities; and
- (b) the rights attaching to those securities.

It is not sufficient that each statement in the prospectus document is factually accurate. Liability may also arise not only for untrue information but also for misleading information or omissions.

Potential liability areas

- (a) Pursuant to Regulation 14 of the POS Regulations, the persons responsible for the prospectus may be liable to pay compensation to any person who acquires any of the securities concerned and who suffers loss in respect of those securities as a result of any untrue or misleading statement in the prospectus or the omission from it of any matter which should have been included under the general duty of disclosure referred to above.
- (b) The directors of the company may also incur civil liability under the placing or underwriting agreement, details of which are set out

later in this chapter. Such agreement is likely to contain warranties, representations and indemnities from the directors of the company given to the sponsor or merchant bank acting on behalf of the company. In the event that there is a breach of any of the warranties, representations and indemnities, the sponsor or merchant bank would be entitled to claim damages from the directors on behalf of purchasers or subscribers for securities for any losses that they suffer.

- (c) A director may also incur liability at common law in relation to the prospectus for deceit or negligence in its preparation.
- (d) Criminal liability. Under Section 47(a) FSA it is an offence for a person i) to make a statement, promise or forecast which he knows to be misleading, false or deceptive, or ii) dishonestly to conceal any material fact, or iii) recklessly to make (dishonestly or otherwise) a statement, promise or forecast which is misleading, false or deceptive if he does so for the purpose of inducing, or is reckless as to whether it may induce, another person to enter into or offer to enter into an investment agreement. An offence pursuant to this section can be committed if a person makes a false or misleading statement 'recklessly', even though he does not realise that it is false or misleading. Case law in this area has established that a person is 'reckless' if, before doing an act, he either fails to give any thought to the possibility of there being a risk of harmful consequences or having recognised that there is a risk of harmful consequences such that an ordinary prudent individual would not feel justified in ignoring, nevertheless goes on to do it.
- (e) Section 19 Theft Act 1968 makes it a criminal offence for any officer of a company to publish, with intent to deceive its members or creditors about its affairs, a written statement or account which 'to his knowledge is or may be misleading, false or deceptive in a material particular'.
- (f) Section 57 FSA 1986 prohibits the issue of an 'investment advertisement' unless it has been approved or issued by 'an authorised person' under the FSA. An investment advertisement includes any form of advertisement, whether written or oral, which, broadly, either invites persons to enter into an investment agreement or contains information which is calculated to lead directly or indirectly to a person entering into an investment agreement. There are both civil and criminal sanctions for breach of Section 57 and

any investment agreement entered into pursuant to an unauthorised investment advertisement will be unenforceable and any sums paid as a consequence are recoverable. Compensation may also be payable for any loss suffered.

Verification

In view of the potential liabilities set out above, it is essential that every director should believe, and should have reasonable grounds for believing, that:

- (a) each item of information contained in the prospectus is not only in accordance with the facts, but is also not misleading in its context;
- (b) all expressions of opinions are reasonably based and properly held;
- (c) the prospectus gives all such information as is necessary to give a true and fair view of the company's business prospects and nothing has been omitted which is necessary to enable investors to make an 'informed assessment' of the company.

In order to satisfy the directors' obligations, a process called 'verification' is carried out in respect of the prospectus and any placing proofs that are issued to prospective placees prior to publication of the final form prospectus. It is therefore standard practice to prepare detailed verification notes effectively proving each and every statement in the prospectus, ideally by external authoritative sources, and explaining and justifying the basis upon which any statements of opinion are based. The purpose of these notes is to record the source of each fact and the person responsible for checking its accuracy such that a permanent record is then retained in the event of a claim under any of the provisions referred to above.

Material changes

If, between the issue of the prospectus and the commencement of dealing in the securities on any market, a director becomes aware of any significant new matter or change affecting any matter contained in the prospectus, that director must immediately inform the company and the sponsor or merchant bank with a view to considering whether it is necessary to issue a supplementary prospectus.

One of the purposes of the prospectus is to ensure that all potential investors are given equality of information relating to the company upon which to base any decision to invest. It is therefore imperative that internal systems are established such that none of the directors or senior employees gives information to a potential investor which is not contained within the prospectus or otherwise made available to all with a view to influencing that investor's decision as to whether or not to apply for shares.

Placing agreement/underwriting agreement

Another key document in the flotation process will be the placing or underwriting agreement to be entered into between the company, its directors and the merchant bank.

Under the terms of a placing agreement, the merchant bank or issuing house will agree to use its reasonable endeavours to procure subscribers for the shares at a set placing price. The company appoints the merchant bankers as agents to procure contracts for subscription of shares between investors and the company.

In the case of an underwriting agreement or, indeed, an underwritten placing, the underwriter or merchant bank will agree not only to use reasonable endeavours to find investors for the shares, but also to underwrite the investment, ie to purchase any shares which are not taken up by investors. This latter method, while clearly a more expensive option for a company seeking admission, at least guarantees the raising of the funds sought.

As mentioned above, a placing or underwriting agreement will also contain indemnities given by the directors to the merchant bank in respect of:

- (a) breaches of the Yellow Book rules and any other statute or statutory regulation in relation to admission;
- (b) inaccuracies in the prospectus;
- (c) any liability incurred by the merchant bank in carrying out its obligations and duties under the placing or underwriting.

In addition, it is common practice for the directors and the company to provide the merchant bank with warranties that:

- (a) the prospectus is accurate and not misleading;
- (b) the financial information is accurate;

- (c) since the date of the last audited accounts of the company there has been no material adverse change in the financial or trading prospects of the company;
- (d) the company is properly insured and holds all licences necessary for the continuation of its business;
- (e) there is no litigation ongoing against the company save as disclosed in the prospectus;
- (f) the company's tax affairs are in order and up to date.

Orderly market

It is also common for a merchant bank or a sponsor to insist upon provisions relating to an orderly market for dealings in the shares of the company. This may be dealt with within the body of the placing or underwriting agreement or by means of a separate orderly market agreement if intended to catch shareholders who are not also directors. Effectively, the agreement places a restriction on the parties to it not to sell all or a proportion of their shares in the company for a particular period of time without the consent of the merchant bank. Its purpose is to prevent the dumping of shares and a potential collapse of the market for that company's shares within a period of 1–2 years following flotation.

Continuing obligations of directors

Once the company's shares have been admitted to dealing on a recognised investment exchange, there are then further substantial requirements placed upon the directors. While the purpose of this chapter is designed to deal with the process leading to flotation, it should be noted that these continuing obligations include:

- (a) reporting requirements to the company announcements office of the London Stock Exchange of any major developments, financial condition changes or other price-sensitive information;
- (b) directors' interests and those of any connected person of the director in the securities;
- (c) changes to the board of the company;
- (d) publication of annual and half-yearly accounts;
- (e) dividends and any other distributions in relation to the shares.

Furthermore, the company becomes subject to the provisions set out in the City Code on Takeovers and Mergers in respect of any acquisition or disposal which it may undertake and/or material changes in its shareholder base. The City Code and Yellow Book primarily set out these provisions.

In addition, the company is obliged to adopt the Model Code for Share Dealing by its directors and certain of its employees. The Model Code's principal requirements are:

- (a) a director must not deal in any securities of the company on considerations of a short-term nature;
- (b) a director must not deal in any securities during the company's close period, namely prior to announcement of annual or half-yearly reports;
- (c) a director must not deal in any security of the company while in possession of unpublished price-sensitive information.

Conclusion

To conclude, while the flotation process is undoubtedly a material step in the history of any company, it is also a time-consuming and testing period for those involved. A strict timetable will be established at the outset of the flotation process, an example of which is set out in Table 4.4.1 (overleaf), and any directors involved must take great care to obtain advice on their obligations in light of the substantive liabilities which they could incur.

Table 4.4.1 Timetable for listing

Preliminary	<ul style="list-style-type: none"> • Appointment of professional advisers • Company's constitution changed (if necessary) • Accountants' long-form report commissioned • First draft of prospectus compiled • Impact date booked with Bank of England (if applicable)
D -60	<ul style="list-style-type: none"> • Long-form report available • Drafting meetings for prospectus
D -30	<ul style="list-style-type: none"> • Completion EGM convened • Verification process begun • Draft prospectus submitted to Stock Exchange for its consideration
D -14	<ul style="list-style-type: none"> • '14-day documents' submitted to Stock Exchange include: <ul style="list-style-type: none"> – prospectus; – application forms to subscribe for shares; and – accountants' reports
D -3	<ul style="list-style-type: none"> • Completion EGM held
D -1	<ul style="list-style-type: none"> • Final version of verification noted approved by board • Completion board meeting held • Final version of prospectus submitted to Stock Exchange • Price of shares finalised
D (Impact Day)	<ul style="list-style-type: none"> • Offer for sale agreement exchanged • Stock Exchange approves prospectus • Prospectus registered at Companies House • Underwriting arrangements completed • Sub-underwriting letters sent to sub-underwriters
D + 2	<ul style="list-style-type: none"> • Publication and advertising
D + 3	<ul style="list-style-type: none"> • '48-hour documents' submitted to Stock Exchange
D + 5	<ul style="list-style-type: none"> • Application for listing heard by Stock Exchange
D + 6	<ul style="list-style-type: none"> • Application lists opened and closed
D + 7	<ul style="list-style-type: none"> • Basis of allotment announced
D + 12	<ul style="list-style-type: none"> • Letters of acceptance or rejection posted to investors
D + 13	<ul style="list-style-type: none"> • Admission to listing on Stock Exchange effective • Dealings in shares commence
D + 53	<ul style="list-style-type: none"> • Last day for splitting letters of acceptance
D + 55	<ul style="list-style-type: none"> • Last day for registration of letters of acceptance