

MMS Smartguide™

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# Guide to the Companies Act 2006

— provisions affecting directors



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## Introduction

The Companies Act 2006 is the result of the most comprehensive review of UK company law since 1985, and is the largest piece of legislation passed in the UK.

This Smartguide™ is one of a series of guides and communiqués dealing with the various aspects of the Act. It covers those parts of the Act of particular interest to directors of both private and public companies, and how these provisions will affect them in their involvement with their companies.

The Government decided to implement the Act in stages, with most of the provisions affecting directors taking effect on 1 October 2007, provisions relating to conflicts of interests, minimum age and natural directors on 1 October 2008 and provisions dealing with directors' residential addresses on 1 October 2009.

All references to “the Act” and to section numbers are references to the Companies Act 2006. References to “the 1985 Act” are to the Companies Act 1985.

## Appointment and removal

All companies must have at least one director who is a natural person (in addition to any corporate directors), so that there will always be someone who can be held to account for the acts or omissions of the company. A company which had only corporate directors on 8 November 2006, when the Act received Royal Assent, has until 1 October 2010 to comply with this requirement.

Private companies need have only one director; public companies must have at least two.

Directors must be at least 16 years of age; if a director was younger than 16 on 1 October 2008, he will have ceased to be a director on that date.

The 70 year age limit for directors of public companies was repealed on 6 April 2007. An ordinary resolution is sufficient to remove a director, but special notice must be given and the resolution must be proposed at a meeting rather than by written resolution, so that the director has the right to be heard.

## Registers

A company must keep a register of its directors, which has to be available for inspection at the company's registered office, or at another specified place notified to the Registrar of Companies. The Act makes certain changes to the details which should be included in the register, which are effective from 1 October 2009.

For a corporate director, the register of directors must include its registered number as well as its registered office.

For an individual, the register of directors must include any name he has used for "business purposes" within the previous 20 years, including where a name has been changed on marriage, but it will no longer include details of other directorships held or held in the past.

In an attempt to provide some protection to individual directors from pressure groups and activists, the

Act provides for a director to provide a service address for inclusion on the register of directors, rather than a residential address. A director can specify "the company's registered office" as his service address. The service address can be the same as the director's residential address, but the public record will not show this.

In addition to the company's register of directors, which is publicly available, the company must keep a separate register of the usual residential addresses of individual directors, in case it is needed by a regulatory authority. This record will not be available for public inspection. If a director's residential and service addresses are the same, the register of residential addresses need only state so, unless the director has specified "the company's registered office" as his service address.

Both the directors' service and residential addresses must be supplied to the Registrar. The residential address, or the fact that the service and residential addresses are the same for a director, will be kept confidential to the company and to the Registrar.

Note that residential addresses already held by the Registrar will still be available on the public record, and will not be removed.

If there is a change in a director's service or residential address, the Registrar must be notified. If there is a change in the service address but no resulting change in the director's residential address, a statement that no such change is required must be sent with the notice to the Registrar.

From 6 April 2007 the company need not keep, or disclose, records of shareholdings of, or share dealings by, directors and their families.

## Directors' duties

Prior to the Act, directors' general duties were governed largely by case law and equitable principles. One of the main, and controversial, changes to company law introduced by the Act was the codification of these duties into a statutory statement. In interpreting and applying these duties, however, the Act states that regard is to be had to the existing common law rules and equitable principles governing directors' conduct.

The new law is not completely self-contained. Directors' obligations under other laws such as health and safety, environmental, competition and insolvency remain. Directors of quoted companies will also have to comply with the rules of the relevant regulatory authority.

The Act emphasises that a director's duties are owed to the company and only the company can enforce them, though shareholders may be able to bring a derivative action on the company's behalf. Breach by a director of any of these duties will make the director liable in damages to the company and render any affected transaction voidable at the option of the company. Conduct which would otherwise be a breach of duty may be approved in advance by ordinary resolution of the shareholders. It is also possible for the company to ratify a breach of duty by an ordinary resolution of the shareholders, although this may be more difficult to do under the Act since the director in breach is no longer able to vote on the resolution (see below: Derivative actions; Directors' liabilities).

The new rules apply to shadow directors where and to the extent that the equivalent common law rules or equitable principles apply to them. Certain duties (e.g. duty to avoid conflicts of interest and duty not to accept benefits from third parties) also apply to former directors. More than one duty may apply in any given circumstances.

The seven general duties set out in the Act are:

### 1. Duty to act within powers

A director must act in accordance with the company's constitution and must only exercise his powers for the purposes for which they are conferred.

### 2. Duty to promote the success of the company

A director must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its shareholders as a whole. He must have regard, amongst other matters, to:

- the likely consequences of any decision in the long term
- the interests of the company's employees
- the need to foster business relationships with suppliers, customers and others

- the impact of the company's operations on the community and the environment
- the desirability of the company maintaining a reputation for high standards of business conduct, and
- the need to act fairly as between the shareholders of the company.

Note that this list is not exhaustive. The aim is to achieve "enlightened shareholder value" and to widen social responsibility for directors when making decisions. Despite this, the duties are owed by the directors to the company alone, although (as was the position before the Act) directors must, for example, consider the interests of creditors in the event of possible insolvency.

Directors of charitable companies must consider these factors in the context of achieving the charitable purposes for which the company was formed.

This section of the Act has provoked much controversy and commentary, particularly given the increased possibilities for derivative actions it provides. "Success" is not defined in the Act; in Parliamentary debates Lord Goldsmith commented that, for a commercial company, it should be interpreted as the long-term increase in value of the company. The Government has also implied that, as before, so long as a director makes a decision in good faith, using care, skill and diligence when considering the various factors, then the courts will be reluctant to interfere with his judgement.

Lord Goldsmith stated that a complete paper trail showing consideration in detail of each factor for every decision of the board is not necessary. This view is reflected in guidance issued by the GC100 group of General Counsel and Company Secretaries of the FTSE 100, which states that formal board processes need only specifically record consideration of the directors' duties where the particular circumstances make it particularly necessary or relevant.

### **3. Duty to exercise independent judgement**

A director must exercise independent judgement, but this does not prevent him from delegating if the company's constitution allows it (for example, to a committee dealing with a specific issue, or to managing or other executive directors) so long as he uses independent judgement when assessing the information provided.

This duty is not infringed if a director acts in accordance with an agreement entered into by the company or in a way authorised by the company's articles.

### **4. Duty to exercise reasonable care, skill and diligence**

The level of care, skill and diligence expected has two elements (as under the Insolvency Act 1986 in the context of wrongful trading); the care, skill and diligence which would be exercised by a reasonably diligent person with:

- the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company (an objective test); and
- the general knowledge, skill and experience that that director actually has (a subjective test).

The specific responsibilities of a director and the circumstances surrounding the particular decision will be relevant to the level of duty expected; a director who has more experience, knowledge and skill or who has relevant qualifications will have to meet a higher threshold.

### **5. Duty to avoid conflicts of interest**

A director must avoid any situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company. This applies in particular to the exploitation of any property, information or opportunity, even if the company itself could not take advantage of it.

Note that this duty does not apply to transactions between a director and the company. These are dealt with separately – see below.

The statutory duty is broad enough to catch potential as well as actual conflicts, and requires a director to avoid any situation where a conflict might arise in the future. For example, where a director holds directorships in more than one company, the duty may be infringed if the interests of the companies might conflict in the future, even if there is no actual conflict at present.

There are two situations in which a director will not infringe this duty:

- if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest; or
- if the matter has been authorised by the directors.

The directors of a private company can authorise a director's conflict so long as there is nothing in the articles which prevents this (and, in the case of a company incorporated before 1 October 2008, if the shareholders have passed an ordinary resolution confirming that the directors should have this power). In the case of a public company the directors must have express permission in the articles to authorise directors' conflicts. For authorisation by the directors to be effective, the director who has the conflict may not vote on the matter nor be counted in the quorum at the meeting at which the conflict is to be considered.

Under the old case law, directors' conflicts could only be approved by shareholders; allowing authorisation by the independent directors is a significant relaxation of this requirement.

## **6. Duty not to accept benefits from third parties**

A director must not accept any benefit from a third party which he receives because he is a director, or because he does or does not do something as a director. This does not include benefits from the company, its holding company or subsidiaries, or benefits resulting from the director's service contract.

This duty is not infringed if the benefit cannot be reasonably regarded as likely to give rise to a conflict of interest.

Benefits to a director from third parties can only be authorised by the shareholders of the company, not by the board (see below).

## **7. Duty to declare interest in proposed transaction or arrangement with the company**

A director must declare to the other directors the nature and extent of any interest, either direct or indirect, in a proposed transaction or arrangement with the company, even if he is not a party to it.

The declaration must be made before the company enters into the transaction or arrangement. It can be made by notice in writing, which can be in hard copy or electronic form (if the recipient director has agreed to electronic communication), or by general notice (for example, that the director has an interest in any contract with a particular person or company), or at a board meeting.

If the declaration proves to be, or becomes, incomplete before the company has entered into the transaction or arrangement the director must make a further declaration.

A director need not declare an interest if:

- he is not aware of the interest or of the transaction or arrangement in question; he is deemed to be aware of matters of which he ought reasonably to be aware
- it cannot reasonably be regarded as likely to give rise to a conflict
- the other directors are already aware of it or ought reasonably to be aware of it; or
- it concerns terms of his service contract which have been or are to be considered at a board or board committee meeting.

Subject to any restriction in the company's articles, a director may still vote and be counted in the quorum at the meeting considering the transaction or arrangement in which he has declared an interest.

## Declaration of interest in existing transaction or arrangement

In a similar way to that in which a director must declare any interest in a proposed transaction or arrangement with the company, he is also obliged to declare any interest, direct or indirect, in an existing transaction or arrangement with the company. The declaration must be made as soon as reasonably practical (for example, on his appointment as a director). No further declaration need be made by a director who has declared an interest when the transaction or arrangement was proposed.

The main difference between declaration of interests in a proposed transaction or arrangement and in an existing transaction or arrangement is in the penalties associated with breach.

Breach of the duty to declare an interest in a proposed transaction carries civil penalties, so that the transaction would be voidable at the instigation of the company and the director would have to account for profits to the company, whereas breach of the requirement to declare an existing transaction carries criminal penalties for the director but the transaction would still be valid.

The sole director of a company need not declare his interest in an existing transaction or arrangement with the company, unless he is the sole director of a company which ought to have more than one director, in which case he must record his declaration in writing.

## Derivative actions

Only the company has a legal right of action for any wrong done to it, not the individual shareholders. Under the old case law a shareholder could bring an action on behalf of the company (for example, against a director in breach of his duty to the company) if the company itself (in practice, the other directors) chose not to take that action. The Act increases the range of circumstances in which a shareholder can bring such a derivative action beyond those previously available (for example, a shareholder will be able to bring a derivative action for breach of duty by a director even if that director has received no personal benefit from the breach).

A derivative action may be brought in respect of a claim arising from an act or omission involving negligence, default, breach of duty or breach of trust by a director or a shadow director.

The action can be against a third party instead of or as well as the director, although the Government has said that derivative claims against third parties will be allowed only in very limited circumstances where there is clear evidence of deliberate third party help (for example, knowing assistance in a breach of trust by a director, or knowingly accepting the transfer of company property in breach of duty).

A shareholder must first apply to the court for permission to bring a derivative action. If the court decides there is no prima facie case, it must refuse the application. Otherwise it may adjourn proceedings or grant the application. If a prima facie case has been established, the court can require evidence from the company.

The court must refuse permission to continue the action if:

- a person acting in accordance with the duty to promote the success of the company would not bring the claim; or
- the act or omission complained of has been authorised or ratified by the company.

In deciding whether or not to give permission to continue, the court must consider a number of factors including: the good faith of the applicant; whether the act or omission is likely to be authorised or ratified; whether the company had decided to pursue the claim; whether a shareholder could pursue the claim in his own right rather than on behalf of the company; the views of independent shareholders; and the importance which a person acting in accordance with the duty to promote the success of the company would attach to the claim.

If the company brings a claim and then discontinues it, a shareholder can continue that claim as a derivative action, or if one shareholder discontinues a derivative claim then another shareholder can take it up.

There has been a good deal of discussion about the possibility of derivative actions being brought by activist or mischievous shareholders (for example, to frustrate a proposed takeover), particularly in the light of the apparent increased requirements for director accountability and the uncertainty over how the directors' duty to promote the success of the company is to be judged, and the extent to which it should be documented.

The burden of proof being placed on the shareholder making the application to prove a prima facie case, together with the requirement for the views of shareholders who have no personal interest in the matter, and the ability of the court to make any appropriate costs order, is designed to reduce claims brought purely to cause trouble, or fishing applications to obtain information by political or pressure groups. In reality, given the hurdles which have to be overcome in order to bring a derivative action, a huge increase in the number of derivative actions is considered to be unlikely.

The greatest danger is probably to listed companies which will be more concerned about potential adverse publicity generated by claims, even if those claims do not ultimately succeed. It would be wise, however, for companies to check that their Director and Officer (D&O) insurance policies cover derivative actions to a satisfactory extent.

## Transactions which require approval of shareholders

There are four types of transactions by directors which always require shareholder approval:

### 1. Directors' service contracts

Shareholder approval is required for directors' service contracts in excess of two years (rather than five years under the 1985 Act). If the company agrees to a provision which breaches this requirement then that provision is void, and the company can terminate the contract at any time on reasonable notice.

A director's service contract is defined for the first time, and includes contracts of service, contracts for services and letters of appointment. It includes services a director undertakes to perform personally and makes available through a third party to the company, and is not restricted to contracts to perform services outside the scope of the ordinary duties of a director.

The company must keep a copy of all directors' service contracts, irrespective of their duration and including contracts of directors working abroad, at the registered office for at least one year after expiry or termination. Shareholders can inspect them free of charge.

Shareholders also have the right, on payment of a fee, to request a copy of a director's service contract, which must be provided within seven days. Any qualifying third party or pension trustee indemnities given by the company to its directors (see: Directors' liabilities) are subject to similar provisions.

The same requirements apply to service contracts with shadow directors.

### 2. Substantial property transactions

The principle in the 1985 Act that shareholder approval must be obtained where a company buys or sells a "substantial" non-cash asset from or to a director or director of its holding company or connected person is retained, but with a major relaxation. The Act allows a company to enter into such arrangements without prior shareholder approval where the arrangement is conditional on shareholder approval being obtained. If a director of the company's holding company, the arrangement must also have been approved, or be conditional on being approved, by the shareholders of the holding company.

Where the company's shares are officially listed or traded on a stock exchange, it will also need to consider the relevant regulatory rules on related party transactions, such as those contained in the Listing Rules or the AIM Rules.

A non-cash asset is “substantial” if it has a value exceeding either £100,000 or 10% of the company’s asset value, subject to a minimum threshold. This threshold has been raised from £2,000 to £5,000, so a property transaction of less than £5,000 in value will not need shareholder approval whatever the company’s asset value.

If any of the provisions on substantial property transactions are breached, the arrangement will be voidable at the instance of the company, unless restitution of the subject matter (money or other asset) is no longer possible, the company has been indemnified for its loss, or the rights acquired by a bona fide purchaser for value without actual notice would be affected. If an arrangement is affirmed by the shareholders within a reasonable period after the breach, it can no longer be avoided.

### 3. Loans to directors

The general prohibition in the 1985 Act on loans by a company to its directors has been replaced in the Act with the requirement to obtain shareholder approval.

All companies may make loans, give guarantees or provide security for loans to directors of the company or its holding company, with shareholder consent. If a director of the holding company, its shareholders must also approve the transaction.

Public companies and any private company associated with a public company must obtain shareholder approval before they can make quasi-loans to directors, make loans or quasi-loans to connected persons, or enter into credit transactions with directors or connected persons.

A private company is “associated” with a public company if one is a subsidiary of the other or both are subsidiaries of the same corporate body, i.e. if they are within the same group. Any such arrangements will have to be disclosed in company accounts. Again, a company whose shares are officially listed or traded on a stock exchange must also comply with the relevant regulatory rules on related party transactions, such as those contained in the Listing Rules or the AIM Rules.

The Act requires a written memorandum stating the nature of the transaction or arrangement, the amount and purpose of the loan, guarantee or credit transaction and the extent of the company’s liability as a result of it to be provided to shareholders before they give their approval.

There are exceptions when shareholder consent is not required under the Act.

These include:

- expenditure on company business below £50,000 (if the value of a transaction cannot be determined it is deemed to exceed £50,000 and would therefore require consent)
- expenditure in defending criminal or civil proceedings in connection with alleged negligence, default, breach of duty or breach of trust by the directors (any loan to a director under this provision must be repaid if he is convicted or judgement is given against him)
- expenditure in connection with regulatory investigation or action

- minor and business transactions (the maximum values of permitted exemptions have been increased: small loans and quasi-loans from £5,000 to £10,000 and small credit transactions from £10,000 to £15,000)

- credit transactions in the ordinary course of the company's business on similar terms as to an independent person

- intra-group transactions; and

- loans and quasi-loans by money lending companies in the ordinary course of their business.

A transaction entered into in breach of these provisions is voidable at the instigation of the company and any gains must be accounted for. If the shareholders affirm the transaction within a reasonable period it will be no longer be voidable.

#### 4. Payments for loss of office

Payments for loss of office or employment include payments to a director or past director by way of compensation for loss of office as a director, or for loss of any other office or employment in connection with the management of the company.

All payments over £200 are caught if they result in a benefit to a director, irrespective of the effect on the company. Non-cash benefits are included.

The need for approval from shareholders has been extended to include payments made to connected persons and to directors of a company's holding company.

## Directors' liabilities and indemnities

Any provision that exempts a director from liability for negligence, default, breach of duty or breach of trust in relation to the company is void, and the company is not allowed to indemnify a director against these liabilities. The company may still, however, purchase D&O insurance against such liabilities, and can indemnify a director against certain third party claims (qualifying third party indemnity provision (QTPIP)) and claims arising as a result of a director acting as trustee for a company pension scheme (qualifying pension scheme indemnity provision (QPSIP)).

A company cannot provide an indemnity against the liability of a director to pay a fine imposed in criminal proceedings or a penalty to a regulatory authority in respect of non-compliance by that director, although it can pay the director's defence costs so long as the director repays them if his case is unsuccessful.

Conduct by a director amounting to negligence, default, breach of duty or breach of trust relating to the company can be ratified by the shareholders by ordinary resolution, unless the articles specify a higher threshold. The director (and connected persons) may not vote on the resolution if it is considered at a meeting, though he can still take part and be counted in the quorum; if a written resolution is used he cannot take part in the procedure. This is more restrictive than the law before the Act, where a director's breach of duty could be ratified by ordinary resolution without disregarding the director's (and connected persons') votes. This may mean that it will now be more difficult to get breaches ratified and could result in a greater likelihood of success for derivative actions.

Since 20 January 2007 directors will no longer be held responsible to investors or third parties for innocent misstatements in directors' reports (see: Directors' reports).

## Directors' reports

The directors must prepare a report for each financial year stating the names of all directors and the principal activities of the company for that year. If a directors' report is not prepared, each director will be guilty of a criminal offence, unless he took all reasonable steps to comply with the requirement.

For all companies other than small companies (i.e. those which are not a quoted company and to which at least two apply of: annual turnover £6.5m or less; balance sheet total £3.26m or less; average of 50 or fewer employees) the report must contain a business review. The purpose of the business review is to inform the shareholders and to help them assess how the directors have performed in their duty to promote the success of the company.

The business review must contain a fair review of the business and a description of the main risks and uncertainties facing the company. It should be a balanced and comprehensive analysis of the development and performance of the company's business during the financial year and its position at the end of it, consistent with the size and complexity of the business.

Quoted companies must also include in their business review "to the extent necessary for an understanding of the development, performance and position of the company's business", using financial and other key performance indicators:

- the main trends and factors likely to affect the future development performance and position of the company's business

- information about environmental matters, the company's employees and social and community issues; and

- information about persons with whom the company has contractual or other arrangements which are essential to the business.

Following concern that this last provision would force companies to reveal confidential or business-sensitive information about their suppliers or other business contractors, a proviso was inserted at a late stage during the passage of the Act which allows the directors not to disclose information about a person if that disclosure would, in the directors' opinion, be seriously prejudicial to that person and against the public interest.

If the directors of a quoted company have nothing to report on environmental, social and community matters or information about persons with whom the company has business contracts, the report must state so.

Medium-sized companies (i.e. those which are not quoted and to which at least two apply of: turnover £25.9m or less; balance sheet total £12.9m or less; average of 250 employees or fewer) need not report non-financial key performance indicators.

Directors can omit from the business review information about impending developments or matters still under negotiation if, in their opinion, disclosure would be seriously prejudicial to the interests of the company.

Details of any QTPIPs and QPSIPs must be disclosed in the directors' report, and copies of them kept and made available for inspection by shareholders for at least one year after they have expired or been terminated.

A director will only be liable to compensate the company for any loss it suffers as a result of any untrue or misleading statement in, or omission from, the directors' report, directors' remuneration report or summary financial statements (to the extent derived from the directors' report or directors' remuneration report) if the director knew or was reckless as to whether the statement was untrue or misleading or knew the omission to be dishonest concealment of a material fact.

Directors' liability in respect of these reports is only to the company, not to investors or other third parties. This section of the Act has been in force since 20 January 2007.

## Connected persons

The Act extends the definition of “persons connected with a director” so that it now includes:

- the director's spouse or civil partner
- the director's children or step-children (whether or not under the age of 18)
- any other person (of same or different sex) with whom the director lives as a partner in an enduring family relationship, but not the director's grandparent or grandchild, sister, brother, aunt or uncle, nephew or niece (“family relationship”, “enduring” and “as a partner” are not defined)
- any children or step-children of the director's partner who are under 18 and who live with the director; and
- the director's parents.

## Conclusion

The Act contains provisions which will affect directors in their day-to day management of the company, and in their longer-term planning and development of the business. Some of these are merely minor changes to the current law which will require little change to current practice. Others, however, may lead directors to consider how they carry out their roles, and their relationships with shareholders.

In particular, perhaps the change which has resulted in most speculation and commentary is the codification of directors' duties for the first time. One of the aims of the Act in codification is to give greater clarity, structure, guidance and certainty to directors in the performance of their duties in relation to the company.

The increased range of circumstances in which a shareholder may bring a derivative claim against a director for breach of his duty to the company has led to concerns that the number of derivative claims will increase, and that there is a real possibility that such claims may be utilised by certain shareholders to attempt to damage the company, even if their claim does not proceed or succeed. Such concerns are, perhaps, more justified in the case of larger "high profile" companies whose activities have historically resulted in their being targeted by activist groups.

There is, it could be argued, little in the new codified provisions that imposes significantly more onerous burdens on, or provides a greater threat to, directors who have always carried out their duties in a responsible manner, in accordance with the previous law and good corporate governance, and who continue, in good faith, to do so.

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