
Part 3: Share capital and capital maintenance

December 2006
Given the size and complexity of the Companies Act 2006, this Guide does not purport to contain a comprehensive summary of the Act’s provisions but merely to highlight changes to company law which we believe to be of particular interest. This Guide is intended to give general information only, and should not be relied on as legal advice.

Please refer to www.linklaters.com/regulation for important information on the regulatory position of the firm.
Introduction

This is Part 3 of our Guide to the reforms to company law effected by the Companies Act 2006 (the “Act”). The Guide is intended as an introduction to the major issues for listed companies and their UK subsidiaries arising from the Act, and reflects the position as at 15 December 2006. The other Parts of the Guide, which can be obtained on request from your usual contact at Linklaters, are:

Part 1: Directors and derivative claims
Part 2: Narrative reporting, liability and auditors
Part 4: Company administration

Scope of the Act

When the Act was first introduced in the House of Lords in January 2006, as the Company Law Reform Bill, it was described as “gargantuan”.¹ In the course of its passage through Parliament, around 400 additional clauses were introduced, and hundreds of amendments made. It is now said to be the largest piece of legislation ever passed by Parliament, with 1300 Sections and 16 Schedules. Its impact on the administration and management of UK companies will be correspondingly far-reaching – not so much because there are many radical reforms, but because of the sheer number of more modest changes.

The Act restates existing companies legislation and introduces wide-ranging reforms

The growth of the Act during its progress through Parliament was largely not the result of substantive new measures being added. Instead, it came about because of the restatement of existing provisions of the 1985, 1989 and 2004 Companies Acts.² These Acts are therefore repealed, with the exception of a small number of provisions – principally those dealing with community interest companies and with investigations (as these apply more widely than to companies). The Act is longer than the existing Companies Acts in part because the drive for simplification has led to a less concise, but easier to understand, drafting style.

The reforms contained within the Act have a variety of provenances, including:

– the Company Law Review commissioned by the Government in 1998 – this involved a large number of practitioners, business people and academics in a wide-ranging consideration of how existing company law could be improved upon,

– various Law Commission recommendations (the Law Commissions are independent bodies established by Parliament to keep the law under review and recommend reforms), and


Based on these initiatives, the Government developed the new law with the key objectives of:

– enhancing shareholder engagement and a long-term investment culture,

¹ Lord Hodgson of Astley Abbotts, Hansard col. 188, 11 January 2006.

Linklaters | December 06
– ensuring better regulation and a “think small first” approach,
– making it easier to set up and run a company, and
– providing flexibility for the future.

The Act is in many respects deregulatory – with private companies benefiting most – but there are also a number of areas where new obligations or potential burdens are introduced, particularly for publicly-traded companies. The result is a widening of the gap between the regulatory burden for publicly-traded companies and that for private companies, which could encourage more businesses to stay, or go, private.

Implementation timetable

The Act was granted Royal Assent on 8 November 2006. A small number of its provisions came into force on that date, or are expected to be effective from January 2007. These include provisions regarding:
– electronic communications with shareholders,
– electronic filings with the Registrar of Companies,
– the implementation of the Transparency Directive, including conferring on the Financial Services Authority new rule-making powers with respect to periodic reporting and major shareholding disclosures, and
– a new regime on the liability of issuers and directors for financial and narrative reporting.

The Government has committed to bring the remaining provisions into force by October 2008. This extended implementation period is necessary, because there remains a great deal of work to be done before the new companies legislation is complete. In particular:
– the Act requires many detailed provisions to be laid down in secondary legislation. No regulations have yet been released in draft for public consultation. The Act also provides for new forms of model Articles for public and private companies, and for companies limited by guarantee. Although some initial consultation has taken place, further consultation on these documents is expected in 2007, and
– the Government has stated that it intends to consult early in 2007 on how certain provisions of the Act will apply to existing companies. An initial consultation on this topic took place during the summer of 2006 and it is clear that complicated secondary legislation will be required to deal with matters such as allotment authorities, memoranda of association and pre-emption rights.

Until the full legislative package is nearer completion, it will be difficult for companies to make definitive plans as to how to deal with implementation. The Government has, however, promised to consult in February 2007 on its detailed implementation plans and to “work with the business community to ensure widespread and effective communication of the Act’s provisions so that all parties fully understand the new provisions and are in a position to take advantage of the benefits”.

Executive summary

The reforms relating to share capital are mostly highly technical in nature, but do include some important measures, most of which are deregulatory. They include:

- the abolition of the concept of “authorised share capital”,
- the removal of the requirement for a private company with only one class of share capital to obtain shareholder approval before allotting shares,
- the introduction of a legislative power to reduce, by secondary legislation, the minimum period for a pre-emptive offer of shares to a company’s shareholders from 21 to 14 days, so opening up the possibility of reduced underwriting commissions,
- pre-emptive offers must in all cases be sent to shareholders throughout the EEA,
- the abolition of the statutory prohibition on private companies giving financial assistance for the purchase of its own shares, leaving in place (unamended) the prohibition on public companies,
- the introduction of a new procedure for private companies to reduce share capital without court approval,
- the introduction of a legislative power to specify in what circumstances a reduction of capital can result in the creation of distributable profits,
- confirmation that an intra-group transfer at book value, where the market value of the asset transferred is higher, does not require distributable profits equal to the difference, if the company has distributable profits when the transfer is made,
- the introduction of a procedure enabling both public and private companies to redenominate all or part of their share capital into a foreign currency without court approval,
- a simplified regime for the variation of class rights, and
- restriction of the uses of a company’s share premium account.
Share capital and capital maintenance

The reforms relating to a company’s share capital are mostly highly technical in nature, but do include some important deregulatory measures. While deregulatory, some of them are also mandatory – for example, the abolition of the concept of authorised share capital. As a result of this, familiar filings with the Registrar of Companies will take a different form. Other routines, such as authorising the directors to allot shares, will also be affected.

Overall, the benefits of the changes in this area should outweigh any new burdens. In particular, the abolition of financial assistance for private companies has long been campaigned for, and will reduce the cost and complexity of many corporate transactions. It will also be very helpful to have resolved the long-standing debate over the requirement for distributable profits in the context of intra-group transfers at book value. The new regime for private companies to effect a reduction of capital without court sanction may also prove popular as companies continue to seek ways to address the distributable profits issue following the impact of IFRS and increased pension liabilities.

Authorised capital

The familiar concept of authorised capital is being abolished, so eliminating the rather cumbersome dual requirement for a company, in order to allot and issue new shares, to have both “authorised but unissued share capital” and shareholder authorisation to allot shares comprised in that share capital. Under the Act, shares can simply be created and allotted by Board resolution, subject to the necessary shareholder authorisation as described below. The requirement to state a company’s share capital in its constitution will cease.

The Government has consulted on transitional provisions, and raised the possibility of existing companies being restricted from allotting shares beyond the amount of authorised share capital until the Articles (which going forward will contain details of authorised capital previously set out in the Memorandum of Association – see “Constitutional reforms” in Part 4 of this Guide) are amended by the elimination of references to authorised capital. This seems a sensible solution which preserves the status quo in the meantime.

Allotment of shares

Shareholder authorisation to allot shares

The regime governing the power of directors to allot shares, and to grant rights to subscribe for, or to convert any security into, shares, is amended and restated (Sections 549–551). The only substantive change from the existing regime is the exclusion of private companies (including subsidiaries of public companies) with only one class of share capital from the allotment authority regime. This exclusion does not, however, override whatever restrictions on allotments (and grant of subscription or conversion rights) may be imposed by the company’s Articles outside the statutory regime. This provision renders unnecessary the provision in the 1985 Act allowing a private company, by elective resolution, to confer allotment authorities on directors for a fixed period exceeding five years, or for an indefinite period, and accordingly this has not been carried through into the Act.
There is an important change of terminology which will have an impact at least on AGM notices, Articles of Association and accounts disclosure. This is the abolition of the concept of “relevant securities”, which currently covers both shares, and rights to subscribe or convert into shares. Shares and rights to subscribe/convert are now dealt with separately under the allotment authorisation regime. As a consequence, the wording of routine allotment authorities (or “authorisations”, following the new term used in the Act) at AGMs will need to be adjusted. In addition, companies (including many of our clients) which have “enabling provisions” in their Articles of Association, allowing annual renewal of their allotment authorisations at the AGM by a short resolution, will need to amend their Articles to reflect the change.

Transitional provisions are likely to provide that allotment authorities under the existing statutory provisions remain valid until expiry in accordance with their terms. This will enable companies to seek authorisation under the new legislation at a convenient time – for example, at the 2009 AGM, assuming the commencement date for these provisions will be October 2008. Allotment authorities under the existing regime could be sought at the 2007 and 2008 AGMs in the normal way (assuming, in the case of the 2008 AGM, it is held before 1 October 2008).

Pre-emptive offers and disapplication of rights

The statutory pre-emption regime for new issues of equity under Sections 89–95 of the 1985 Act is amended and restated (Sections 560–577) and is left broadly unchanged. However, there are three important new provisions relating to pre-emptive offers of new securities to shareholders:

- The first is the inclusion in the pre-emptive offer regime of a legislative power (exercisable by statutory instrument) to reduce the mandatory 21-day period for pre-emptive offers to not less than 14 days. This could helpfully shorten timetables for some equity issues, potentially reducing underwriting costs. No indication has yet been given that advantage will be taken of this power to reduce the offer period, but it seems likely that there will be strong pressure from both public companies and the financial services industry to do so.

- The second is that the period of the pre-emptive offer can commence when the offer is sent (whether by hard copy (for example, post) or in electronic form) – at present, the period cannot begin before receipt of the offer by all shareholders. This change will also be beneficial in terms of reducing underwriting periods and costs.

- The third relates to the communication of a pre-emptive offer to shareholders. Currently, the 1985 Act enables the offer to be made to shareholders with no registered address in the UK (and where no service address in the UK has been given) by publication of notice in the London Gazette, and this is a well-used method to avoid possible infringement of overseas securities laws in the context of public offers of securities. This provision is being adjusted to be available only for shareholders with no registered or service address in the EEA, with the result that pre-emptive offers will have to be made into an EEA state, regardless of the compliance requirements under local securities legislation. This “anti-discriminatory”
measure mirrors a similar change to the Takeover Code made at the time of implementation of the EU Takeover Directive (20 May 2006) and will (like that measure) require analysis of local securities laws, particularly where there is a significant body of shareholders outside the UK.

As under the existing legislation, private companies (including subsidiaries of public companies) will be able to exclude the requirement to make pre-emptive offers to shareholders, or adjust the manner in which such offers are made, by provision to that effect in their Articles. Where private companies choose not to exclude the operation of the pre-emption regime, they can pass a special resolution (or include a provision in the Articles) disapplying the statutory pre-emption requirement, either for a specific allotment or for allotments generally. For those private companies with one class of share capital only, any such disapplication need not be tied to an allotment authorisation (and so need not be limited in time) as no such authorisation is required under the Act for such companies (as explained above). For all other private companies (and all public companies), a disapplication resolution must (as at present) always be linked to an allotment authorisation, so that shares allotted under a disapplication must also be covered by an allotment authorisation. When the allotment authorisation is used up or expires, the related disapplication also ceases to have effect.

The restatement of the statutory pre-emption regime will require some adjustment to routine AGM “pre-emption right disapplication” resolutions and Articles of Association (where these contain wording to facilitate short disapplication resolutions at the AGM) to reflect the adjusted provisions.

There has been no formal consultation on transitional provisions for pre-emption rights, but it seems likely that existing disapplications will remain valid until their expiry date.

**Alteration of share capital**

Public and private companies are permitted under Sections 121–123 of the 1985 Act to increase, consolidate, divide, sub-divide and cancel their share capital by ordinary resolution and a notification regime is established requiring notice of any such alteration of share capital to the Registrar of Companies. These “actions” relate in some cases to “authorised” share capital only (e.g. increase and cancellation), in other cases to both “authorised” and issued. The abolition of authorised share capital requires this list of actions to be updated.

In addition, the list of actions in the 1985 Act is not comprehensive – it does not, for example, cover purchase, redemption or forfeiture. Under the Act, there is a comprehensive and definitive list (Section 617) of methods by which a company is permitted to alter its share capital.

As explained below, the Act introduces a simplified process for redenominating share capital from one currency to another without the need to apply to the court for a capital reduction, as at present. This complements the common law rule that shares may be denominated in any currency, and that different classes of shares may also be denominated in different currencies, which is captured in statute for the first time (Section 542(3)).
The notification regime for any alteration of share capital will require the filing with the Registrar of Companies of a “Statement of Capital” giving the precise number of issued shares and specified details about those shares, including nominal value, the amount paid up or unpaid on each share, and the rights attached to each class of shares. This requirement extends to the basic “return of allotments” (currently dealt with in Section 88 of the 1985 Act). The DTI has at last relented and given up the requirement to file originals or certified copies of contracts conferring the entitlement to allotment; this requirement has often given rise to concerns over confidentiality of sensitive information contained in the contract.

**Financial assistance**

The 1985 Act currently prohibits any private or public company from giving financial assistance for the purpose of an acquisition of shares in the company or its parent. This is subject to certain exemptions and, in the case of private companies, a whitewash procedure.

The prohibition on financial assistance will be abolished by the Bill in so far as it relates only to **private** companies. The regime will remain essentially unchanged (Sections 677-683) in relation to (i) financial assistance given by a **public** company (or any of its UK subsidiaries)\(^4\) for the purpose of the acquisition of shares in that company while it remains a public company, or (ii) financial assistance given by a public company subsidiary of a private company, for the purpose of the acquisition of shares in that **private** company.

The changes will greatly simplify **private company** acquisitions, public-to-private transactions (once the target has converted into a private company) and internal group reorganisations. Loans, guarantees or security given by a private company to finance its acquisition will be permitted and will no longer need to be authorised by the “whitewash procedure”, which involves approval by special resolution, a directors’ solvency declaration and a report by the auditors. Directors of private companies giving financial assistance will, however, still need to consider the Act’s codified general duties and common law maintenance of capital rules.

Concerns were raised during the parliamentary debates on the Bill as to whether common law rules regarding maintenance of capital (based on the rule in *Trevor v Whitworth*)\(^5\) may still operate to prevent a private company from giving financial assistance for the purpose of the acquisition of its own shares. The Government decided against making any express adjustment to the amended legislation to meet this concern, arguing that it was unnecessary to do so. However, the Government has promised\(^6\) that a “savings” provision will take effect on commencement, confirming that the removal of the prohibition on private companies giving financial assistance for the purchase of their own shares will not prevent such companies entering into transactions which they

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\(^4\) Under existing legislation, the prohibition extends to **all** subsidiaries, but case law has established that the financial assistance prohibition does not have extra-territorial effect and so does not apply to subsidiaries not incorporated in the UK (*Arab Bank v Merchantile Holdings* [1994] 2 All ER 74).

\(^5\) (1887) 12 App Cas 409.

\(^6\) Lord Sainsbury of Turville, Hansard col. 443, 2 November 2006.
can lawfully enter into under the existing whitewash procedure. The Government’s intention appears to be that the relaxation of the prohibition on private companies effected by the Act will not revive any common law which existed before the introduction of the prohibition and was overtaken by it. The precise wording of this savings provision will be critical; it is not clear to what extent the conditions of the whitewash procedure – such as that the assistance must not reduce net assets or, to the extent it does, must be provided out of distributable profits – will need to be satisfied to enable reliance on the savings provision.

The financial assistance regime will remain in place for public companies, and the new legislation therefore does nothing to clarify the regime in its application to public companies, so that (for example) the scope of the “wider purpose” exemption – rarely relied on due to Lord Oliver’s somewhat opaque judgment in Brady v. Brady\(^7\) – remains as unclear as it has been since first enacted in 1981. However, the Second Company Law Directive, which provides the basis of the financial assistance prohibition under European law, has recently been amended\(^8\) to enable public companies to provide financial assistance for the acquisition of their own shares, subject to a whitewash procedure similar to (but significantly more onerous than) that currently available to UK private companies. This relaxation of the public company financial assistance regime is unlikely to be implemented in the UK before 2008.

### Reductions of capital

At present all reductions of capital by limited companies require approval of the court, whose principal function is to satisfy itself that the company’s creditors will not be prejudiced by the reduction. The involvement of the court builds extra time and cost into the procedure and it has long been thought that an adequate level of protection can be afforded to creditors outside a court process.

Under the Act (Sections 642–644), private companies will in future have the ability to reduce their capital without court approval by way of a special resolution supported by a solvency statement. For public companies, court approval will still be required.

The solvency statement is required to state that each of the directors has formed the opinion that the company is solvent and will continue to be able to pay its debts as they fall due during the year immediately following the date of the statement. If the statement is made without reasonable grounds, each director in default will be guilty of an offence punishable by a fine and/or imprisonment.

A consensus will need to be developed as to what the directors should do in order to show that they had “reasonable grounds” in forming the opinions expressed in the solvency statement. The DTI decided that it was unnecessary for the solvency statement to be supported by an auditor’s opinion (as, for example, in the case of a financial assistance whitewash), but directors may take the view that they require comfort on solvency from their auditors. There is

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\(^7\) [1989] AC 755.

\(^8\) Directive 2006/68/EC.
also the question as to whether directors of private companies will choose to use this method, rather than the familiar court-approved reduction, as directors who make the solvency statement without having reasonable grounds are at risk of criminal sanctions.

One of the commonest reasons for reducing capital is to create distributable reserves. At present, the accounting profession recognises that the reserve which arises on a reduction of capital automatically constitutes a realised profit where the court has approved the reduction. This is reflected in guidance (TECH 7/03) issued jointly in 2003 by the Institute of Chartered Accountants in England and Wales (ICAEW) and the Institute of Chartered Accountants in Scotland. The accounting profession has long sought statutory underpinning for this approach and strong representations to that effect were made by the ICAEW to the Government during the parliamentary process. The Government appears to have relented, and a new statutory provision (Section 654) means that a reserve arising from the reduction of a company’s share capital will now only be distributable in cases to be specified in regulations made under that Section. At present, there is no indication as to whether the Government proposes to make regulations or what cases they may cover, although it seems probable that those circumstances in which TECH 7/03 recognises that a reduction gives rise to a realised profit will be covered. What is not clear is whether, and/or to what extent, reductions by private companies without court approval will be included. It would seem perverse if they were not.

This may also present an opportunity to revisit the onerous conditions which apply to a reduction of capital by an unlimited company (for which court approval under the 1985 Act is not possible) in order for a reserve arising on a reduction of capital to be distributable.

**Intra-group transfers**

Currently, the law governing distributions to shareholders, including distributions in kind, is contained both in Part VIII of the 1985 Act and the common law. “Distributions in kind” can include transactions such as an intra-group transfer of an asset at an undervalue. For many years, there has been concern that, in the context of intra-group reorganisations, common law principles may require a company to have distributable profits covering the difference between book value and market value of any asset transferred at book value. This concern was aggravated in 1989 by the leading case of *Aveling Barford*, which established that, where a company which does not have any distributable profits transfers an asset to a shareholder at less than market value, this will be an unlawful distribution.

The Act introduces a new statutory provision (Section 845) which determines the quantum of a distribution in kind where a company proposing to make such a distribution has positive distributable profits. It confirms the principle (for many years accepted by leading company lawyers) that, where a company has some (i.e. greater than zero) distributable profits and transfers an asset to a shareholder at not less than book value, there is a distribution but the amount of the distribution is zero. Where the transfer is made at less than book value, the uncertainties arising from Aveling Barford are being resolved.

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9 *Aveling Barford Ltd v Perion Ltd and others* [1989] BCLC 626.
the amount of the distribution is equal to the difference, and will need to be covered by distributable profits. This provision expressly overrides any common law rule to the contrary (Section 851). However, in relation to other (cash) distributions, it will still be necessary to consider the common law and, in relation to all distributions (cash and in kind), it will still be necessary to have regard to a company’s constitution and any applicable statutory provisions (e.g. the codified general duties of directors).

For the purposes of this provision, a company’s profits available for distribution are increased by the amount (if any) by which the consideration received for the asset transferred exceeds its book value. Accordingly, the “profit” arising on transfer will be taken into account when determining whether the company’s distributable profits are positive and so can take advantage of this provision. This means that, in principle, a company with negative distributable profits (say, minus £1,000) can lawfully sell an asset intra-group at £1,001 in excess of its book value even if the market value is significantly higher than book value. But a sale at book value would be an unlawful distribution.

Although this new provision does no more than confirm what many believe to be the correct legal analysis under existing law, it is most helpful to have it set out in statute for the first time, so resolving the many uncertainties which have existed in this area for company lawyers and their clients.

**Redenomination of share capital**

Currently, the only way in which a company can convert its shares from one currency to another under existing law is by way of a court-approved reduction of capital. A company may wish to do this, for example, if its income and cost base are largely expressed in a foreign currency, so that it makes commercial sense to prepare its accounts in that foreign currency. Unless its share capital is denominated in the same currency as its functional accounting currency, the company may find that the translation of an amount standing to the credit of share capital account creates an unwelcome volatility in year-end results.

The Act will facilitate redenominations into a different currency (Sections 622–628):

- unless its Articles provide otherwise, a company will be able to convert some or all of its share capital into a foreign currency by simply passing an ordinary resolution changing the nominal value of the shares. A resolution can be made conditional, but the conditions must be satisfied within 15 days of the resolution being passed,
- where the redenomination produces a strange nominal value per share, it will be possible by special resolution passed within three months of the resolution effecting the redenomination to reduce the company’s share capital to achieve a more suitable nominal value. The amount by which the company’s share capital is reduced must not exceed 10 per cent of the nominal value of the company’s allotted share capital immediately after the reduction. The amount of the reduction has to be transferred to a “redenomination reserve” which can only be used for paying up bonus shares,
– if it is desired to increase the new nominal value of the shares, it will (as is the case at present) be possible to apply distributable reserves to adjust the nominal value.

This new procedure avoids the need for involvement of the court and allows what ought to be sufficient flexibility in calculating an equivalent amount in foreign currency.

**Variation of class rights**

The 1985 Act provides a complicated regime for the variation of class rights. For most companies, this regime is an irrelevance as modern Articles of Association typically include a provision dealing with variation of class rights which will override the statutory regime in most cases. Even where it does not, the statutory requirements are essentially the same as a company’s Articles, requiring either consent in writing of holders of 75 per cent of the issued shares of the relevant class, or an extraordinary resolution passed at a separate general meeting of the holders of that class.

Although the Government originally proposed to embed in statute a minimum requirement for a variation of class rights (notwithstanding any less demanding requirement in the Articles), a last-minute change reverted to the existing principle that the Articles (whatever requirements they prescribe) should determine the variation of rights procedure. Only if the Articles do not provide for the variation of class rights does the statutory regime take over. This is expressed in significantly clearer language than the 1985 Act, but its substance is unchanged from the existing regime, except that a special resolution is required rather than an extraordinary resolution (because the “extraordinary resolution” concept is being abolished).

As at present, any amendment of a provision contained in the company’s Articles for the variation of the rights attached to a class of shares, or the insertion of such a provision in the Articles, is itself to be treated as a variation of those rights.

**Share premium account**

The 1985 Act requires the transfer to “share premium account” of any excess over nominal value when shares are allotted at a premium (whether for cash or non-cash assets), subject to the “merger relief” provisions (which disapply this requirement) in the context of share-for-share acquisitions satisfying strict criteria. The share premium account is treated as share capital under the maintenance of capital regime, although certain specific uses are permitted.

Under the Act (Section 610), the available uses of the share premium account are to be limited, as set out in the table below:
### Share premium account: permitted uses

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<tr>
<th>1985 Act</th>
<th>Change under the Act</th>
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<tbody>
<tr>
<td>Paying up fully paid bonus shares</td>
<td>No change</td>
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<tr>
<td>Writing off</td>
<td>Prohibited in the case of issue of debentures</td>
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<tr>
<td>- expenses</td>
<td>In the case of issue of shares, only the premium on the issue of those shares may be used</td>
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<td>- commissions paid</td>
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<td>- discounts given</td>
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<tr>
<td>relating to the issue of new shares or debentures</td>
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<tr>
<td>Writing off “preliminary expenses”</td>
<td>Prohibited</td>
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<tr>
<td>Providing for premium payable on redemption of debentures</td>
<td>Prohibited</td>
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The restriction of uses for the share premium account will mean it will be harder to take advantage of share premiums, although in practice, for mature listed companies, the more usual uses of the share premium account – writing off share issue expenses (including underwriting commissions), bonus issues and as a “pot” available where a reduction of capital is undertaken – will remain available.
Further information

If you would like to discuss any aspect of the Companies Act 2006, please contact Lucy Fergusson (0207 456 3386), Steven Turnbull (0207 456 3534) or your usual contact at Linklaters.