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A legal update from Dechert's Corporate and Securities Group

Abolition of Financial Assistance Prohibition Relating to Private Company Acquisitions

One of the biggest changes contemplated by the Companies Act 2006 (the "Act") came into force on 1 October 2008: the partial repeal of the Companies Act 1985 financial assistance provisions. A private company is no longer prohibited from giving financial assistance for the purchase of shares in itself or shares in its private holding company. In addition, as the "whitewash" procedure was only ever available to permit the giving of financial assistance by private companies, 1 October 2008 also heralded the end of the whitewash procedure.

However, this does not mean that financial assistance can be totally ignored in relation to a private company because, as required by EU law, the prohibition on the giving of financial assistance by a public company remains in force. Accordingly, a private subsidiary of a public company will still be prohibited from giving financial assistance in respect of an acquisition of shares in that public company.

Although the abolition of the prohibition in relation to the giving by a private company of financial assistance in respect of the acquisition of shares in a private company will simplify many corporate transactions, such as group reorganisations and leveraged buy outs, there will still be a degree of specialist legal analysis required where financial assistance is provided by a private company. This is because there will remain in force elements of English law which need to be considered when financial assistance is provided and which were, for the most part, covered by the protections inherent in the whitewash procedure.

The old statutory whitewash procedure involved the directors swearing a declaration of solvency, the auditors confirming the reasonableness of that declaration, a shareholders' resolution and, usually, a separate report on net assets by the auditors.

Under the whitewash procedure, consideration needed to be given to the following in respect of the company giving the financial assistance (*emphasis added*):

- the company having positive *net assets* which are not reduced by the giving of financial assistance (or if that assistance involves a reduction in net assets, that such reduction is covered by *distributable profits*); and
- the company being *solvent* both before and after the giving of financial assistance and being able to pay its debts for a twelve month period following the giving of financial assistance.

In addition, the giving of financial assistance also involved consideration of *directors' duties* and *corporate benefit*. Although the whitewash procedure will no longer be applicable, there is still a backbone of that whitewash procedure that will still be relevant and necessary for the directors to consider in the context of a financial assistance transaction, and these are described in more detail below.

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Net Assets

The most common form of financial assistance provided in a corporate transaction relates to the giving by a private company of a loan, guarantee or security to support the acquisition of shares. Under the whitewash procedure, consideration would therefore be required to be given to the effect of the financial assistance on that company's net assets and post 1 October 2008, this analysis will still be necessary. If the financial assistance reduces net assets, then, unless this reduction is covered by distributable reserves or the statutory capital reduction procedures are utilised, then such reduction will constitute an unlawful capital reduction. It is established market practice that the granting of a loan or guarantee/security should have a neutral effect on a company's net assets unless the directors are concerned that the guarantee/security is likely to be called or that the loan is likely to be unpaid, in which case, they should require a provision to be made in the company's accounts. Any such provision will represent a liability which will correspondingly reduce that company's net assets. Under the whitewash procedure, if there was any such reduction, then that reduction had to be covered by distributable profits.

Distributable Profits/Unlawful Distribution

Under the old financial assistance provisions, a lawful payment of a dividend could not constitute financial assistance. In addition, company law has always made it clear that a distribution to a shareholder shall be unlawful unless it is made out of distributable profits. "Distribution" is widely defined and accordingly, care must be taken to examine the financial assistance proposed to be provided in order to confirm that it is a transaction for the corporate benefit of the company concerned and that it is not gratuitous (and in a scenario where this distinction is hard to make, that any such transaction is covered by distributable profits). Under the Act, directors are personally liable in respect of an unlawful distribution, and a cautious director should always seek some protection from this personal liability by obtaining shareholder approval to the making of any such distribution (although this will not shelter them against any claim by creditors).

Solvency/Transactions at an Undervalue

Under the old whitewash procedure, a company was required to consider, by reference to the financial assistance being provided by it, both its own solvency position and the solvency position of the entities to which it was providing financial assistance. This involved current and future cash flow considerations of that company and the requirement that the directors confirm that they were confident that the company could continue to pay its debts now and for the next twelve months. This solvency check will still be crucial to follow because if the company providing the financial assistance is insolvent or the effect of providing the financial assistance will push that company into insolvency, then the transaction may be at risk of challenge as being a transaction at an undervalue under the Insolvency Act 1986 (as well as a breach of directors' duties). In any scenario where solvency issues are a concern, then the directors must shift their alignment of interests away from the shareholders to ensure that the interests of creditors are suitably protected. Under the old whitewash procedure, a company with negative net assets could not use the whitewash procedure and, from 1 October 2008, the directors of an insolvent company will need to consider carefully whether (and to what extent) it will be possible for an insolvent company to provide financial assistance.

Directors' Duties

Another big change brought about by the Act is the statutory codification of directors' duties, which now means that there is a particular chapter of the Act dealing with directors' duties to consider and follow when considering financial assistance. Section 172 of the Act requires the directors to consider whether the transaction would be most likely to promote the success of the company for the benefit of its members. In practice, however, the common law directors' duties have always had to be considered when analysing the effect of financial assistance, so this will not represent a change in practice. Again, cautious directors should always seek shareholder approval, although as explained previously, this will not shelter them from claims by creditors.

Corporate Benefit

In considering any transaction involving financial assistance, the directors must consider whether the giving of that financial assistance is in the best

interests of the company and what benefit the company will receive from that transaction. It is common in a leveraged finance transaction for a subsidiary company to provide security and cross-guarantees in relation to the acquisition of shares in its holding company. Careful consideration will need to be made of the corporate benefit to that subsidiary company resulting from its entry into that type of transaction, and the higher the risk, the greater the corporate benefit needs to be. Moreover, the directors must consider the best interests of the subsidiary as a whole and as a separate legal entity from its parent. This is because English law does not recognise a concept of "group benefit", i.e., it is not enough to show a benefit to the group as a whole; the subsidiary's directors must act on behalf of that specific company (although it would be proper for that subsidiary to consider not only the direct benefits accruing to it, but also the indirect benefits which might reasonably be expected to accrue). Again, cautious directors should always seek shareholder approval, although as explained previously, this will not shelter them from claims by creditors.

Conclusion

The abolition of financial assistance in relation to private limited companies represents a sea change in English corporate law and will help to simplify transactions. However, it does not mean that one can simply wave through financial assistance transactions involving private companies. There will still need to be legal (and financial) analysis relating to the effect of the financial assistance to be considered and, although the whitewash procedure will be a thing of the past, issues covered by that procedure will still need to be taken into account. It will be interesting to see how lenders react to the changes. Will they still require a formal (or modified) "whitewash" exercise to be carried out? The reports of the demise of financial assistance may, in fact, turn out to have been somewhat exaggerated.

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