# The City of London Law Society

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**THE IMPLICATIONS FOR LEVERAGED TRANSACTIONS OF THE REPEAL OF THE STATUTORY PROHIBITION OF FINANCIAL ASSISTANCE BY PRIVATE COMPANIES**

**Joint Memorandum of the Financial Law and Company Law Committees of the City Of London Law Society**

The City of London Law Society (CLLS) represents over 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This joint memorandum has been prepared by the Financial Law and Company Law Committees of the CLLS. These Committees are made up of solicitors who are expert in their field.

## Objective

The objective of this memorandum is to record some consensus views of members of the two committees on the principles of company law that have to be taken into account in relation to transactions by private companies that, before the repeal of the financial assistance prohibition[1], would have been unlawful, for being in breach of the financial assistance prohibition unless sanctioned using the "whitewash" procedure[2].

## The principles

The effect of the repeal of the financial assistance prohibition is that financial assistance transactions by private companies (in respect of the shares of a private company) are no longer unlawful per se. However, the following general company law principles should continue to be taken into account:

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[1] The prohibition of financial assistance under s151, Companies Act 1985.

[2] The procedure that allows financial assistance to be given by private companies, under s155 to 158, Companies Act 1985.

- the transaction must be in the best interests of the company ("likely to promote the success of the company for the benefit of its members")[3];

- the transaction must not breach the rules on distributions or otherwise constitute an illegal reduction in the capital of the company.

In addition, the validity of the transaction may be called into question as a transaction at an undervalue for the purposes of s238 Insolvency Act 1986.

**Practical implications**

*Best interests of the company*

The requirement to show that the transaction is in the best interests of the company may be considered in the same way as any other "upstream" commitment by a subsidiary for the benefit of other members of the group and the following may be considered as practical measures to give assurance that this requirement is met:

- board minutes that confirm the board has considered the matter and concluded that the transaction should be approved. It may be helpful to identify the "corporate benefit" in the minutes (whether tangible (guarantee fees) or intangible (the benefit of remaining part of the group)) and the board's assessment of the solvency of the company;

- approval by a shareholder resolution, which can reduce or eliminate the risk of a company/shareholder challenge based on breach of duty by the directors (the risk remains of a challenge if the company is insolvent, or is threatened by insolvency but as to this, see below).

*No reduction of capital*

If the transaction involves an outright transfer of assets to or for the benefit of the shareholders of the company it may amount to a distribution, in which case the statutory rules on distributions[4] must be complied with:

- if it is gratuitous, or

- if it involves a transfer at less than the lower of fair market value and book value (if the company has distributable reserves[5]) or less than fair market value (if the company does not have distributable reserves).

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[3] Where relevant taking into account the matters referred to in s 172(2), Companies Act 2006. If the company is, or is at risk of becoming, insolvent, or would be as a result of entering into the transaction, the interests of creditors will be relevant to determine whether the transaction can properly be entered into.

[4] Part VIII, Companies Act 1985; Part 23, Companies Act 2006.

Any other transaction which involves (or may in future involve) the transfer of assets to or for the benefit of shareholders and involves:

- a gift (not amounting to a distribution),
- a loan[6], or
- a guarantee or indemnity, the grant of security or any other assumption of a liability by the company[7]

may amount to an unlawful reduction of capital if, as a result of the transaction, there would be a reduction in the net assets recorded in the company's books and that reduction exceeds the amount of the distributable reserves of the company.

If a transaction is on arm's length terms, it may be lawful even if the transaction would result in accounting net assets being reduced by more than the distributable reserves of the company. However, such situations are likely to be relatively rare and will require case-by-case analysis.

The effect on net assets should be determined according to normal accounting principles, so that if the transaction does not require an immediate accounting loss to be recognised there will be no effect on net assets. Accordingly, none of the issue of an upstream guarantee, the creation of upstream security or the making of an upstream loan will offend the rules concerning the maintenance of capital unless in the books of the company concerned the loan receivable falls to be recorded at less than the amount advanced or the guarantee or security requires the immediate recognition of a liability (and then only to the extent that the amount of the loss exceeds the distributable reserves of the company).

The steps that should be taken to provide assurance that the validity of the transaction cannot be challenged effectively will depend on the circumstances, but may include:

- being able to demonstrate that the directors of the company entering into the transaction have considered whether it will lead to a reduction in net assets and, if so, the amount of profits available for distribution. This will involve an assessment of the likelihood of any guarantee being called or any loan not being repaid and, under some accounting standards, the market value of a guarantee given or of a loan made. The amount of detail considered appropriate in any such assessment may depend on the degree of uncertainty as to (a) the possibility of a payment having to be made and (b) the potential magnitude of the payment (taking into account any right of indemnity and any right of contribution);

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[5] s845, Companies Act 2006.

[6] This includes any transactions that would have been caught by s152(1)(a)(ii), Companies Act 1985.

[7] This includes any transactions that would have been caught by s152(1)(a)(iii), Companies Act 1985.

- in some circumstances the directors may wish to arrange for an independent review of the cash flows and projections relied on for this purpose or of the processes used to develop them. However, we expect this to be an exception rather than the usual case;

- if the transaction will reduce the accounting net assets of the company and therefore requires distributable reserves in order to be lawful, it may be appropriate to arrange for a detailed review of the distributable reserves position to be carried out and for the auditors to be consulted on the conclusions of that review.

*Insolvency/potential insolvency*

If the company concerned is, or is at risk of becoming, insolvent (or if the transaction causes the company to become insolvent), the risk of challenge to the transaction is much increased[8]. The usual assessment of the creditworthiness of the overall transaction should identify any solvency issues that may exist independent of the proposed transaction. It is likely that the steps outlined above will identify any threat to solvency created by the transaction itself.

**Conclusion: impact on financing transactions**

Although we are aware that some more cautious views have been expressed[9], we believe there is a significant consensus supporting the approach set out above. As a result, we consider that the abolition of the prohibition on financial assistance for private companies will not, by itself, throw up any problems additional to those which have always required consideration when dealing with cross guarantees, upstream loans and upstream security.

We expect, therefore, that procedures adopted to assure interested parties that financing and refinancing of share acquisitions are not vulnerable to legal challenge should now come into line with those familiar to practitioners in other financing transactions.

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**This memorandum does not contain legal advice and does not purport to be a complete statement of the law. Readers should take specific legal advice before entering into any transaction.**

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[8] The transaction may involve a breach by the directors of their duties and may be vulnerable under s238 Insolvency Act 1986.

[9] There is a school of thought that is concerned that any transaction entered into by a company that benefits its shareholders (other than through their ownership of shares in the company) and that may in the future lead to assets being transferred by, or a loss otherwise suffered by, the company entering into it may, at the time it is entered into, constitute a reduction of capital and may therefore be illegal. However, we are not aware of any authority that requires this conclusion nor of any policy that should lead a court to this result.