

FINANCIAL ASSISTANCE

Jack Shepherd - Nabarro LLP

INTRODUCTION

This guide sets out an overview of the regulation dealing with the concept of financial assistance in England and Wales as currently regulated by the Companies Act 2006 ("**Companies Act**") in connection with private limited companies and public limited companies.

GENERAL OVERVIEW

❖ **What are the origins of financial assistance in English law?**

Financial assistance has been a criminal offence since the Companies Act 1929. The current prohibition on the giving of financial assistance is set out in sections 677 to 683 of the Companies Act, which abolished the prohibition on financial assistance by private companies as previously contained in the Companies Act 1985.

❖ **What should be understood as financial assistance under English law?**

Whilst "financial assistance" is not defined in the Companies Act, the legislation gives examples of types of financial assistance. For instance, financial assistance can be given by way of a gift, guarantee, security, indemnity, release, waiver or loan. Financial assistance can also be given by a company where (a) the net assets of the company are reduced to a material extent [usually one per cent (1%) or more] by the giving of the financial assistance or (b) the company has no net assets, being the aggregate of the company's assets less the aggregate amount of its liabilities.

The courts have noted that the potential scope for financial assistance is wide as it has no technical meaning. However, the courts have emphasised that when considering whether a transaction amounts to financial assistance, the commercial realities of the transaction must be considered, bearing in mind that the prohibition is a penal one and is not intended to cover transactions which are not fairly within it. In addition, there must be assistance or help for the purpose of acquiring shares and that assistance must be financial in nature. There is a body of case law which helps to interpret the application of the prohibition in different circumstances.

❖ **Is financial assistance accepted under English law?**

As a general rule, the Companies Act prohibits a public company (or a subsidiary of that company) from giving financial assistance, directly or indirectly, for the purpose of acquiring shares in it.

Whilst the prohibition on financial assistance by private companies was repealed by the Companies Act, there are other rules that need to be considered when a private company is giving financial assistance. For example, are the directors acting within their statutory duties to promote the success of the company and to act in accordance with the company's constitution? And is the company acting in the interests of its creditors?

❖ **Is there any exception under English law as regards the general prohibition of providing financial assistance to third parties?**

There are three (3) types of exceptions to the prohibition on financial assistance. However, only two (2) of them are commonly relied upon in practice. The first are known as the "**unconditional**" exceptions. These refer to a range of activities where the prohibition does not apply, including the distribution of a company's assets by way of a lawful dividend; the allotment of bonus shares; a lawful reduction of capital and a scheme of arrangement made pursuant to a court order.

The other common type of exceptions are referred to as the "**conditional**" exceptions. These are limited to transactions that involve (a) the lending of money by companies where money lending is part of the ordinary business of that company, (b) financial assistance given in good faith to fund an employee share scheme and (c) loans to bona fide employees (other than directors) to enable them to acquire fully paid shares in the company or its holding company. They are only available to public companies if the public company has net assets that are not reduced by the giving of financial assistance, or to the extent that those net assets are reduced, the assistance is provided out of distributable profits.

There is a third type of exceptions, the "purpose" exceptions, which are discussed below.

❖ What are the consequences of providing financial assistance?

A criminal offence is committed if there is a breach of the financial assistance prohibition. The company will be liable to a fine and every officer of the company (including the directors and the secretary) in default is liable to a fine or up to two years' imprisonment or both.

The civil sanctions are dealt with under common law. Any agreement to provide unlawful financial assistance is void and unenforceable. Further, the directors will have to account for any losses suffered by the company if the giving of financial assistance was in breach of their statutory duties owed to the company.

PRIVATE LIMITED COMPANIES

Since the full implementation of the Companies Act, private limited companies are no longer prohibited from giving financial assistance for the purpose of the acquisition of their own shares. However, the prohibition on financial assistance does apply to private companies in certain circumstances. For example, if the private company is a subsidiary of a public company, then it will be prohibited from giving financial assistance for the purpose of the acquisition of shares in its public holding company or from reducing or discharging any related liability. Similarly, if a public company is a subsidiary of a private company, it will be prohibited from giving financial assistance for the purpose of the acquisition of shares in the private holding company or discharging any related liability.

Even though the prohibition on private companies giving financial assistance has been repealed by the Companies Act, any transaction which involves the giving of financial assistance needs careful consideration by the company's directors. There is a broad range of issues which need to be considered, including:

- ***Are the directors acting in accordance with their statutory duties?*** The directors should carefully consider and minute whether the transaction is likely to promote the success of the company for the benefit of its members as a whole and whether they are acting in accordance with the company's constitution.
- ***Does the transaction amount to an unlawful reduction of net assets?*** Under English law, it is unlawful for a company to transfer its capital when it does not have sufficient distributable reserves, without the leave of the court or some lawfully authorised procedure. Such transactions are void.
- ***Is the company acting in the interests of its creditors?*** If the company is insolvent or close to insolvency, then English law gives certain protections to creditors. The transaction could be challenged by creditors if it is at an undervalue or if another creditor has been given a preference. The directors also face personal liability if they are found guilty of wrongful or fraudulent trading. It is recommended that the directors obtain a working capital report before approving the assistance.

PUBLIC LIMITED COMPANIES

General rule

The Companies Act contains four types of prohibition on financial assistance. **First**, a public limited company (or a subsidiary of that company, which could be a private or public company) is prohibited from giving financial assistance, directly or indirectly, for the purpose of acquiring shares in the public company.

Second, if a person has acquired shares in a company (whether public or private) and incurred a liability for the purpose of the acquisition, it is unlawful for that company (or a subsidiary of that company) to give financial assistance, directly or indirectly, for the purpose of reducing or discharging that liability, provided at the time of the assistance the company in which the shares are acquired is a public company.

Third, where a person is acquiring or proposing to acquire shares in a private company, it is unlawful for a public company that is a subsidiary of that company to give financial assistance, directly or indirectly, for the purpose of that acquisition.

Finally, if a person has acquired shares in a private company and incurred a liability for the purpose of that acquisition, it is unlawful for a public company to give financial assistance, directly or indirectly, for the purpose of reducing or discharging that liability.

Exceptions to the applicability of the general rule as regards public limited companies

There are three (3) types of exceptions to the prohibition on financial assistance. First, the prohibition does not apply where (a) the company's principal purpose in giving the financial assistance is not to give it for the purpose of the acquisition, or (b) the giving of the assistance for the acquisition is but an incidental part of some larger purpose of the company, and the assistance is given in good faith in the interests of the company. These are known as the "**purpose**" **exceptions**. However, the courts have interpreted them narrowly so they are rarely relied upon in practice.

Second, the prohibition does not apply to a range of activities, including the distribution of a company's assets by way of a lawful dividend; the allotment of bonus shares; a lawful reduction of capital; a lawful redemption or purchase of shares; a scheme of arrangement made pursuant to a court order; and anything done pursuant to lawful company voluntary arrangement. These are known as the "**unconditional**" **exceptions**.

Finally, the prohibition does not apply where the transaction involves (a) the lending of money by companies where money lending is part of its ordinary business, (b) financial assistance given in good faith to fund an employee share scheme and (c) loans *to bona fide* employees (other than directors) to enable them to acquire fully paid shares in the company or its holding company. These are referred to as the "**conditional**" **exceptions**. They are only available to public companies if the public company has net assets that are not reduced by the giving of financial assistance, or to the extent that those net assets are reduced, the assistance is provided out of distributable profits.

CONSEQUENCES OF PROVIDING FINANCIAL ASSISTANCE

❖ Civil penalties

The civil sanctions are dealt with under common law. Any agreement to provide unlawful financial assistance is void and unenforceable by either party to it. Similarly, any security or guarantee that breaches the prohibition is also void and unenforceable. The courts will usually sever the illegal part of the transaction from the agreement if they are able to do so without changing the subject matter of the transaction.

❖ Liability of the administration body

The directors will have to account for any losses suffered by the company if the giving of financial assistance was in breach of their statutory duties owed to the company. These include the duty to promote the success of the company for the benefit of its members as whole, and the duty to act in accordance with the company's constitution.

As a result of the directors' breach of duty, the courts could also disqualify them from acting as directors for up to fifteen (15) years.

❖ Fines

If there is a breach of the financial assistance prohibition, the company and every other officer (which includes the directors and secretary) in default will commit a criminal offence. The offence carries a maximum penalty of two years' imprisonment or a fine (or both) on conviction on indictment; and up to twelve (12) months' imprisonment or a fine up to £5,000 (or both) on summary conviction.

OTHER RELATED MATTERS

❖ Break fees

In the context of a share acquisition, it is common for the bidder to seek a break fee, whereby the target agrees to pay the bidder a specified sum if certain events are triggered which cause the acquisition to fail, e.g. the target decides that it no longer wants to do the deal.

When negotiating break fees, the parties, and the target in particular, need to consider financial assistance carefully, as the break fee may constitute unlawful financial assistance. For example, if the break fee would reduce the target's net assets by a material extent (usually one per cent or more), the target may be in breach of the prohibition on financial assistance. The City Code on Takeovers and Mergers now contains a general prohibition on deal protection measures such as break fees. In the limited circumstances in which they are permitted, the aggregate value of the break fee(s) must be less than one per cent of the target's market capitalisation, based on the bidder's offer price.

A break fee could also amount to unlawful financial assistance if it acts as an indemnity for the bidder to cover, for example, its costs and fees in connection with the acquisition. To avoid this scenario, the break fee should be expressed as a fixed amount and not be capable of adjustment by reference to the bidder's incurred expenses.

❖ **Commissions**

A subscription for new shares falls within the scope of the prohibition on financial assistance as it is an acquisition of shares. It is generally accepted that there is no financial assistance if the company pays an investor a commission in consideration for his subscription of shares. However, to ensure that the commission is lawful, the Companies Act provides that (a) the company's articles must authorise the payment of the commission and (b) the commission must not exceed the lesser of (i) 10 per cent (10%) of the issue price of the shares and (ii) the amount or rate authorised in the company's articles.
