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Financial assistance: The abolition of whitewash

A Guest Article by Robert Brooks
January 2009

The law up to 30 September 2008

Under section 151 of the Companies Act 1985, financial assistance by a company in the purchase of its own shares was generally prohibited.

However, pursuant to section 155, private companies were able to provide financial assistance upon completion by the directors of a statutory declaration or (since 22 December 2002) a statement stating, in essence, that the company would be able to pay its debts as and when they fell due for a period of at least 12 months after the assistance had been given.

This declaration or statement was supported by an auditors' report given for the purposes of section 156.

This procedure was commonly known as the "whitewash" and was used by purchasers to fund acquisitions by using the assets of the target company to secure borrowings that were then used to pay for the shares in the target.

If the whitewash procedure was not followed, both directors and auditors might become liable.

Unlawful transaction

In one case, the shareholders in and directors of a private company sold their shares and part-funded the purchase by causing the target company to lend the purchaser £210,000 of the purchase price. It was agreed that this transaction was unlawful as the whitewash procedure had not been complied with, because:

1. The directors signed a statutory declaration without making any reasonable enquiries to satisfy themselves that the statement could be honestly made.
2. There were no distributable reserves available to make such a loan.

The company went into liquidation and the liquidator brought a claim against the directors and the auditors.

The court held that the auditors had carried out the audit without enquiring into the affairs of the company to the extent that an auditor of reasonable competence would have done. The auditors were found to be negligent and in breach of the duty they owed to the company as whitewash auditors.

The directors were also found to be liable to the company both for breach of fiduciary duty and in negligence.

The new law

With effect from 1 October 2008 the whitewash procedure has been abolished.

This means that a private company that is the target of an acquisition may provide financial assistance. However, the prohibition still applies to any public company and to any private company that is a subsidiary of a public company if the shares acquired are shares in that public company.

Moreover, directors of companies will still have to be careful to satisfy themselves that it is right for the company to provide financial assistance.

Sections 171 to 177 of the Companies Act 2006 specify the general duties that are owed by a director of a company to a company. These duties include a basic obligation to act in the way the director considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.

In addition to satisfying the general duties contained in the 2006 Act, in deciding whether to permit a target company to provide a guarantee and/or security for lending in order to facilitate the purchase by a third party of shares in that company, the directors will need to give specific consideration to the same issues that they and their financial advisors would have taken into account in issuing an accountants' report and deciding whether or not to swear a declaration of solvency or sign a statement of solvency under the previous legislation.

In other words, they will have to be satisfied that there has been no unlawful distribution or reduction in capital when the assistance is given. They ought prudently to also consider the company's net asset position and whether it will be able to meet its obligations as and when they fall due.

Advice is still crucial

It follows that while the new regime is intended to free up private companies from the costs associated with the whitewash procedure, it would be a brave director indeed who failed to take proper financial advice and to ensure that advice was delivered in writing and carefully noted in the minutes.

Lenders will also want to ensure that proper steps have been taken by the directors to inform themselves before taking any decisions.

Under the previous system, even if the whitewash procedure had been followed, nothing was guaranteed and if the acquisition failed questions might still have arisen as to the efficacy of the decisions taken by the directors.

However, since 1 October 2008 directors have been on their own, and will have to take great care not to leave themselves exposed to liability by ensuring that they take timely professional advice before acting.

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