SHOULD THE BAN ON FINANCIAL ASSISTANCE UNDER COMPANIES ACT 2006 BE ABOLISHED FOR PUBLIC COMPANIES?

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1. Introduction

Financial assistance ban which restricts monetary assistance provided for acquisition of shares in the parent or subsidiary company under UK company Law dates to 1920's. The law under Company's Act 1985 which restricted both public and private companies was reformed in 2006. The reform came into effect on 1st October 2008. From that day, the financial assistance ban was not applicable to private companies anymore while acquiring shares in a private company. Along with the restriction even the associated whitewash procedure which was a gateway from complying with financial assistance rule by private companies was abolished[1]. But the rules regarding public companies had to be kept intact based on The Second Company Law Directive (77/91/EC) which is rooted in European law and had to be complied by all the member countries[2].

This was considered a "long awaited victory"[3] by many, majorly because of the reduction in complexity and costs involved. But at the same time legal experts throughout United Kingdom also recognised the legal problems with not abolishing the same rule for public companies.

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[1] Gaby Hardwicke, 'Briefing Note: Life after Financial Assistance' (May 2016) <http://www.gabyhardwicke.co.uk/images/library/files/briefingnotes/Life_After_Financial_Assistance.pdf> accessed on 8 June 2017

[2] "Whitewash no more: the partial repeal of the Companies Act 1985 restrictions on financial assistance comes into force on 1st October 2008" (Slaughter and May, Financial Brief, August 2008) <https://www.slaughterandmay.com/media/732985/financing_briefing_august_2008.pdf> accessed on 11 June 2017

[3] Norton Rose Fullbright LLP, 'Companies Act 2006: provisions coming into effect in October 2008' (*Lexology*, 15 July 2008) <http://www.lexology.com/library/detail.aspx?g=acbfc502-f1a0-4129-abce-090d1092ddb1> accessed on 8 June 2017

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The prohibition remains a big hindrance for the public companies and in some circumstances, even for private companies. The current law makes it illegal for public companies to provide financial assistance while acquiring shares in public or private company and prohibits private companies to provide financial assistance while acquiring shares in public companies. The biggest challenge of the ban is the sanctions it imposes for its breach. As per the 2006 Act, breach of the financial assistance rule would impose criminal liability on the company as well as all its officers in default, which is very detrimental to the companies and the directors who were involved in the transaction [4].

Even though the whitewash procedure is eliminated which resulted in reduction of high levels of advisory fees by the companies but the limited nature of the exclusion did not completely eliminate these costs. The advisory services would be still required when dealing with public companies[5].

Even initially the Greene committee which was involved with drafting the law had considered the ban to not be "strictly necessary for the principle of capital maintenance". It was recommended that the company should be permitted to give assistance if the members approved[6].

Through this paper I would briefly describe what financial assistance means and what all does the law prohibit among with what was the objective behind the law at its inception. Then I would highlight the core deficiencies of the law which includes – complexity of the language, difficulty in interpretation by the courts, ineffective results in achieving the goal of capital maintenance, existence of other legislatures to combat the problem more efficiently and the changing political and economic structure of UK to reach the conclusion that the ban is outdated and its application must be removed from both private and public companies altogether.

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[4] Tom Pickthorn, James Hunter and Tim Winn, "What you need to know about the Companies Act 2006: Provisions affecting Private companies" (Mills & Reeve LLP, January 2008) <http://www.mills-reeve.com/files/Publication/61c42ee6-87cd-416f-ac08-9b2fdbe9c841/Presentation/PublicationAttachment/df457d1c-3d80-4170-9402-aa0f3b3ebddc/2276.pdf> accessed on 10 June 2017

[5] Ian Mitchel, "Did the Companies Act 2006 abolish financial assistance" (Shepherd and Wedderburn, 9 May 2007) <https://shepwedd.com/knowledge/did-companies-act-2006-abolish-financial-assistance> accessed on 11 June 2017

[6] Jennifer Payne, “Legal Capital in the UK Following the Companies Act 2006” in J Armour & J. Payne (eds), *Rationality in Company Law: Essays in Honour of D D Prentice* (Hart Publishing, 2008)

2. <u>What is Financial Assistance?</u>

Section 677- 683 of the 2006 Act deal with the ban on companies against financial assistance[7].There is no proper definition of financial assistance provided under the law but as per Section 677 of Companies Act 2006, "financial assistance is a rule under which a prohibition is imposed on companies and/or any of its subsidiaries from providing financial assistance to any person/company/institution, either directly or indirectly, for the purpose of acquisition of the company's share. Financial assistance under its definition includes gifts, indemnity, release or waiver, loans, guarantees, securities and leveraged buyouts"[8].

Other circumstances in which financial assistance ban might get attracted is when the net assets are reduced to a material extend (1% or more) or giving financial assistance when the company possesses no assets (liabilities surpass the assets)[9].

3. <u>What was the objective of prohibiting financial assistance and its affects?</u>

The main objective behind the law in the current scenario is to protect the interests of the creditor and the shareholders by protecting company's capital. Because it was argued that if a loan is provided and the borrower defaults then the liability would fall upon the directors. This could lead to potential abuse which might affect the creditors of the company. But because of the confusing language of the statue, financial assistance has been an extremely difficult area under company law[10].

Another historical objective behind the law is enforcing the requirement of capital maintenance. The Greene Committee specified the main objective of introducing the ban to prevent "asset stripping" during takeovers. Asset stripping is a concept under which purchasers would acquire a huge chunk of shares to obtain majority shareholding in the target company and later sell them off

[7] Company Act 2006, Section 677- 683
[8] Catherine Roberts, *Financial Assistance for the Acquisition of Shares*, (first published 2005, Oxford University Press)
[9] Jack Shepherd, "England. Financial Assistance IBA Corporate and M&A Law Committee 2013" (2013) <https://www.ibanet.org/Document/Default.aspx?DocumentUid=9ADE899F-F556> accessed on 11 June 2017
[10] John Lowry, The Prohibition Against Financial Assistance: Constructing A Rational Response" in Dan Prentice and Arad Reisberg (eds), *Corporate Finance Law in the UK and EU*. (Oxford University Press, reprinted 2012)

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to settle loans. This is considered to affect the creditors and thus was considered important under the capital maintenance regime. But the ambit of the ban of financial assistance is much broader than just restricting capital maintenance. It attracts all transactions which would reduce company's net assets.[11]

It was hoped that with the ban in force the companies would be more vigilant in maintaining their capital but a lot of academicians have come to the realisation that the ban on financial assistance does not help achieving that goal[12].

4. Reasons for the Financial Assistance ban to be completely abolished

4.1 Complexity in the language of the law

The language of the law had always been extremely complex and a worry some issue. There were some hopes that with the new legislation some of the complexity would be cleared out. But the new law did nothing of that sort. It just excluded private to private company transactions from the ambit of financial assistance.

Most of the complexities are ingrained in the exemption the financial assistance. One of which is the scope of conditional exemption based on the "principle" and "larger purpose"[13]. The exemption states that if the assistance is given in good faith in the interest of the company and the financial assistance is an incidental part of the larger purpose (which isn't providing financial assistance) then it would be allowed. But the language of this exemption was too broad leading to absurdities and the same was further increased by the court in Brady v Brady.[14]

[11] John Armour, "Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law", The Modern Law Review, Vol. 63, No. 3 (May, 2000), pp. 355-378 <http://www.jstor.org/stable/1097174>
Accessed on 7 June 2017
[12] George Letsas, Colm O'Cinneide, *Current Legal Problems 2010*, Volume 63, (First published 2010, Oxford University Press)
[13] Linklaters, "The Companies Act 2006: A Guide to the Reforms Part 3: Share capital and capital maintenance" (December 2006) <www.linklaters.com/pdfs/Insights/corporate/companiesactdec06_3.pdf> accessed on 8 June 2017
[14] Discussed in next part of the paper.

Defining the scope of the larger purpose has been very difficult and on top of it, the judgment narrowed down the application of the "larger purpose" exemption to almost non-existent. The companies now must be extremely cautious of using this exemption. The benefit that the company derives should not be related to the financial assistance for the rule to be used[15].

4.2 Difficulty by the court to analyse the ban on financial assistance

The interpretations by the courts of this complex law has grown a lot. The way the judges analyse the cases relating to financial assistance has shown considerable change over the course of time. Earlier a very strict interpretation of the statute was witnessed which is now getting more and more relaxed. But some parts still remain deeply complicated.

In 1980, the ban was amplified by the Court of Appeal in *Belmont Finance Corporation v Williams Furniture Ltd.*[16] The facts of this case were that the company in consideration purchased an asset at an inflated price and the vendor used the proceeds to buy the company. The court termed this transaction as financial assistance because the company had not acted in the commercial interest and facilitated the acquisition of the shares by the vendor.

Waller LJ, took the view that to avoid contravention of Section 54 it is not sufficient to show that the assets were worth the price paid. The company must also show "commercial interest of the company". Thus, he implied that if the transaction is "partly with the intention" to acquire the company's shares, notwithstanding that it would be in the commercial interest of the company, it would be a contravention[17].

The reasoning of the court was criticised by Hoffmann J who viewed that if "only or the main purpose of the transaction is to assist the acquisition of shares, the section would be imposed. He further emphasised his view point in 1986 judgment of *Charterhouse Investments Trust Ltd. V Tempest Diesels Ltd.*

[15] Catherine Roberts, supra note 8
[16] *Belmont Finance Corporation v Williams Furniture Ltd* [1980] 1 All ER 393
[17] Ibid

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He stated "One must examine the commercial realities of the transaction and decide whether it can properly be described as the giving of financial assistance by the company, bearing in mind that the section is a penal one, it should not be stretched to cover transactions which are not fairly within it"[18].

In 2003, the decision of *Chaston v SWP Group Plc*.[19] influenced the 2006 Act in a lot of ways. It was a case where a subsidiary company paid 20,000 pounds (out of its 100,000-net worth) arising out of a due diligence report on its parent company for its takeover by a third party. Arden LJ, based on her determination of the commercial substance held that this was financial assistance.

The analyses were based on the fourth category (subparagraph(iv) of subsection (1)(a))) under Section 152 of the Company's Act 1985, *"any other financial assistance given by a company the net assets of which are thereby reduced to a material extent or which has no net assets"*.

The court set some limits and guidelines to the prohibition for the general applicability of the ban which were not included by the 1985 Act.

These included[20] –

1. The prohibition applies even if the assistance is not given to the purchaser.
2. The prohibition also catches assistance given "in connection with" the company's purchase of shares in itself.
3. Section 151 prohibits financial assistance given "directly or indirectly". Moreover, section 151(1) applies even though a person is only proposing to acquire shares.
4. Financial assistance need not always be detrimental. For example, a loan made on terms that are highly beneficial to the company.

[18] *Charterhouse Investments Trust Ltd. V Tempest Diesels Ltd* [1986] BCLC 1 at 10
[19] *Chaston v SWP Group Plc* [2003] 1 BCLC 675
[20] Ibid

5. Due performance of fiduciary duties is not itself enough to avoid a breach of section 151[21].

In *MT Realisations Ltd v Digital Equipment Co. Ltd.*[22] the court made amends to narrow down the scope of the ban as set in the Chaston Case. The issue arose when the subsidiary company (MTR) paid the money owed under a secured loan to its parent company. This sum was utilised for the discharge of the liability incurred in acquiring its shares in the subsidiary company. The problem heightened because MTR had paid directly to the vendor of the shares.[23]

The judge held that "reasoned on the commercial realities of the transaction, financial assistance had not been given for the purpose of reducing or discharging a liability incurred for the purpose of the acquisition of its shares. The parent company did not receive anything beyond what they were legally entitled to. Payment to the vendor was just for commercial convenience."[24]

The commercial realities test applied now is much better than the one applied before because based on this the courts generally choose to not interfere with a transaction which is "in connection with" the acquisition and is not "for the purpose" of the acquisition of shares[25]

The exceptions to the financial assistance are aimed at helping and protecting transactions which are genuine and are in the interest of the company, but the language of the exceptions even in the 2006 amended act is vague which leads to inefficient results. The courts in their interpretation of "larger purpose" "principle purpose" tend to apply the law too narrowly which results in genuine transactions being declared illegal[26].

One case which portrayed this confusion in the interpretation of the courts was *Brady v Brady.*[27] The cause of action in this case was the financing of the bid to acquire shares in the company. Even though the main purpose of the transaction was not to discharge a liability and was for the

[21] *Chaston v SWP Group Plc* [2003] 1 BCLC 675
[22] *MT Realisations Ltd v Digital Equipment Co. Ltd* [2003] 2 BCLC 117
[23] John Lowry, supra note 10
[24] *Ibid*
[25] *Dyment v Boyden* [2005] 1 WLR 792
[26] John Lowry, supra note 10
[27] *Brady v Brady* [1988] 2 All ER 617

benefit of the company, which would attract the exception under Section 155(2) of 1985 Act. But the court rejected the application of the exception by rejecting the "larger purpose" argument.

Lord Oliver reasoned that, for the exception to be applied the larger purpose needs to be something other than acquiring of shares, however beneficial the transaction might be for the company. And he felt that in case of any financial assistance being provided the larger purpose would always be acquisition of shares. He further said that the meaning of "reason" and "purpose" are different. Reason explains why an act is done and purpose exclaims what the transaction in defined to achieve[28].

He said that the mischief that is trying to be contained must always be borne in mind and the distinction in the application of the words "reason and purpose" must be carefully examined[29]. He further added that the reasons for the transaction might have been several which are integral to the smooth functioning of the company such as the company may have fallen into hard financial or managerial situations which requires a change of management. But this reasons could not be accepted as the "larger purpose" of the transaction[30]. He stated that "The purpose and the only purpose of providing financial assistance is and remains enabling the shares to be acquired. And its courts responsibility to interfere to restrict the financial or commercial advantages flowing from the acquisition'[31]

This case is still a good law which shows how the interpretation of the courts has been extremely narrow and against companies. Making it extremely difficult for them to indulge in fair transactions. Post relaxation of the rules for private companies, fair transactions between private companies would not be tied down under unreasonable prohibitions but the activities of public companies are still tied down by these unreasonably restrictive laws. The interpretations of the

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[28] *Brady v Brady* [1988] 2 All ER 617
[29] Ibid
[30] *Brady v Brady* (Swarb.Co.uk, 23 February 2017) <http://swarb.co.uk/brady-v-brady-hl-1988/> accessed on 10 June 2017
[31] *Brady v Brady* [1988] 2 All ER 617

courts would continue to exploit the companies by penalising genuine transactions if the outdated prohibition is not done away with.

4.3 The objective of capital maintenance doesn't justify the ban

Financial Assistance ban is just a small facet of the broad capital maintenance regime. The protection under the ban is not even considered to provide any substantial affect towards achieving the goal. It has been observed by many that the ban is doing more harm than good. A lot of business opportunities which could prove beneficial to not just the company but also its shareholder and creditor have to be let go of because of the ban on financial assistance.

One thing that the capital maintenance rule is trying to curb is the risk of leveraged buyouts (LBOs). Even though the complexity of the LBOs post the 2006 Act have been substantially reduced by excluding private to private company transactions from the ambit of the ban. But the companies could gain even more from the reduced managerial agency cost, incentive of share ownership and high levels of debts provided to manager if even public companies are excluded from the ambit of the ban. The ban is proving to be unnecessarily restrictive for them[32].

Moreover, there are a lot of other corporate decisions which could go against the interests of the creditors but are still not banned by corporate law. If such decisions could be enforceable then why not financial assistance? Most of the times financial assistance could prove to be more beneficial of everyone's interest but it is supressed from by the law and the courts[33]. Examples of some of the inefficiencies in the capital maintenance regime focused on the restriction on distribution to shareholders and reduction of capital are -

1. First, the decision regarding limiting the distribution is based on the balance sheet test. According to this test only the portion of net assets which exceeds the distributable reserves can be paid out to the shareholders. The information which this balance sheet holds has

[32] John Armour, supra note 11
[33] Eilís Ferran, "Corporate Transactions and Financial Assistance: Shifting Policy Perceptions but Static Law", (The Cambridge Law Journal, Vol. 63, No. 1, Mar., 2004), pp. 225-243 <http://www.jstor.org/stable/4509081> accessed on 24 April 2017

minimum connection with the true financial position of the company. It does not record companies net assets based on the going concerns of the company but on historical shareholder contribution. Also, the accounts focus not on protecting creditors from unfair trading and its disadvantages but on guiding investment decisions of the company, which defeats the purpose of using them for capital maintenance to protect creditors[34].

2. Second, these capital maintenance rules have extremely narrow implications. They fail to take into consideration alternate forms of distribution mechanisms such as payment of excessive compensation to shareholders who might be directors of the company, poor investment decisions or fraud by directors.

   The failure of core rules designed to tackle problem of upholding the capital maintenance principle is a prime example of why legislations which pay almost no contribution towards this principle must be done away with for good[35].

4.4 <u>Presence of other laws which govern the regulations of a company's capital</u>

If the ban on financial assistance would be removed in its entirety, it would not provide an open field for the companies to provide financial assistance. There exists a lot of statutory rule relating to reductions and distribution of capital which control the financing habits of the company. Those regulations are enough to control the activities of both public and private companies, there is no need for an additional burden of the ban to regulate the companies.

Some activities which remain prohibited based on statutory rules are-

1. Making a gift to a shareholder to buy more shares in the company during a time when the company has no or insufficient distributable reserve. This would amount to unlawful reduction of the capital[36].

[34] Jennifer Payne, Louise Gullifer, *Corporate Finance Law: Principles and Policy*, (Second edition 2015, Bloomsbury)
[35] Ibid
[36] Keith Wilson and Alper Deniz, " Financial Assistance and the Companies Act 2006" (Paul Hastings, October 2008) <https://www.paulhastings.com/docs/default-source/PDFs/1017.pdf> accessed on 8 June 2017

2. Providing a loan to a shareholder with the knowledge of the shareholder not being in a capacity to repay when the company itself has insufficient or no distributable reserves. This too would be unlawful reduction of capital[37].
3. When companies are trying to return funds to the shareholders they most commonly choose redemption of shares. This isn't financial assistance but involves a payment out of the distributable reserves or even capital (in case of private companies). In case of a return exceeding the distributable reserve, the companies must have a "court sanctioned scheme, reduction under new solvency statement route or a private company purchase out of capital". Choosing any other method would be an illegal reduction of capital[38].

4. Under Section 238 of the Insolvency Act 1986, in case of insolvency of a company, the standards to protect the creditors under English Law come into force. Under English law, creditor could challenge a transaction if it is undervalued or preference is given to another creditor. The directors need to be extremely particular regarding safeguarding the interests of the credits and obtain a working capital report before approving any assistance. Failure to do so could impose personal liability for wrongful and fraudulent trading[39].

Further regulations include the duties of the directors. Directors have responsibilities in place which they must comply with to work for the best interest of the company. The Company Act 2006, under Section 172 imposes the duty to ensure that they work for the success of the company and for the benefit of its members as a whole. They must also ensure that transactions the company enters into do not amount to illegal reduction or unlawful distribution of the funds[40]. The directors could even be held personally liable for "wrongful and fraudulent trading" or in case of a transaction traded at an undervalue, the validity of the financial assistance can be questioned[41].

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[37] Tom Pickthorn, James Hunter and Tim Winn, "What you need to know about the Companies Act 2006: Abolition of financial restriction" (Mills & Reeve LLP, January 2008)
[38] Derek Ellery, "Financial assistance after 1st October" (DWF Law, 13 June 2008) <https://www.dwf.law/news-events/legal-updates/2008/06/financial-assistance-after-1st-october-2008/> accessed on 8 June 2017
[39] Jack Shepherd, supra note 9
[40] Dami Ogedengbe, "Financial Assistance in Acquisition and Structured Financing" (Detail Commercial Solicitors, 4 December 2013) <http://www.detailsolicitors.com/index.php?section=news&cmd=details&newsid=42&printview=1> accessed on 8 June 2017
[41] Norton Rose, supra Note 3

Also, it is the duty of the directors to cross check any doubts that might exist regarding the solvency of the company post the assistance being given. The rule of auditors come into place at this point to review the management's accounts[42].

The fiduciary duties of the directors also include taking care of any conflict of interest that may arise while giving out loans to the directors or the shareholders for the purpose of acquiring more shares. Even though these aren't restricted by the ban of financial assistance anymore but a lot of schemes go into checking the genuineness of the transaction and establishing the chances of recovery[43].

Another argument which is presented by legislators as a justification for the ban on financial assistance is the need to protect the shareholders during the time of acquisition of shares or takeovers. This need to protect the shareholders is already specified under the fiduciary duties of the directors. They are required to use their power in good faith, for a legitimate purpose and must ensure that shareholders are treated fairly. This duty is again reemphasised for public companies specifically through the statutory right of minority shareholder to sell their shares at the fair price during a takeover and the provisions of the City Code on Takeovers and Mergers[44].

Even the immediate lenders to the company might impose contractual obligations that the financial assistance is given in a manner which is beneficial for the company. Lenders too want to ensure that the directors fulfil their obligation while buying securities or guarantees from subsidiary companies[45]. Lenders might also require directors to seek prior approval by their shareholders before indulging in financial assistance. This is supposed to reduce or eliminate future risk on shareholders[46].

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42 Nick Atkins, "Financial Assistance- Update" (Mundays Solicitors, April 2009) <https://www.google.co.in/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&cad=rja&uact=8&ved=0ahUKEwjVkorT_7XUAhUET7wKHTJTB3YQFggtMAE&url=http%3A%2F%2Fmundays.co.uk%2Fdownload%2FMzM0&usg=AFQjCNEcD8PzuiSYP9fHRvt0Pt2Gi2y7YQ&sig2=8B8vWAqdlVIv6J1nSy3VLg> accessed on 11 June 2017

43 Gaby Hardwicke, supra note 1

44 Eilís Ferran, supra note 33

45 Keith Wilson and Alper Deniz, supra note 36

46 Nick Atkins, supra note 42

With the increased duties on the directors under the 2006 Act, the responsibility on the directors, of both private and public companies, has substantially strengthened which would reflect passively in the capital maintenance related regulations of the companies. Which is one reason why the prevalence of the ban for public company has become outdated to fulfil the objective of protecting the interest of creditor and shareholders and capital maintenance.

4.5 Post Brexit, the obligation to follow to Second Derivation of EU would not be compulsory

When the legislation was considering relaxing the laws regarding financial assistance ban, it did recognise the challenges the law imposes on public companies but could not repeal the lawn in its entirety because of the presence of Second Directive of EU law which makes it compulsory for member states to implement the directives through their domestic laws[47].

The official government committee too had concluded during their review of the Company Act 1985 that the ban imposed more drawbacks than protection, that's why they wanted to revise the law in a way to limit the implication of the ban of public companies within the constraints of the Second Directive[48].

But now with Brexit, the situation is set to change. UK is soon going to put into motion its withdrawal from EU after the controversial vote to give up EU membership which implies that UK would no longer be bound to follow the EU directives post the withdrawal. If the legislation wishes to amend the Company Law again then the negotiations can be conducted to get out of the Second Directive obligations. And post the completion of the Brexit the provision of ban on financial assistance could be repealed completely[49].

5. Conclusion

[47] Philippa Richards and Jaya Gupta, "Financial assistance: life after the whitewash" (Thomas Reuter: Practical Law, 29 September 2008) <https://uk.practicallaw.thomsonreuters.com/6-383 4279?service=ld&__lrTS=20170610185019778&transitionType=Default&contextData=(sc.Default)&firstPage=true&bhcp=1> accessed on 11 June 2017

[48] Eilís Ferran, supra note 33

[49] Remus Valsan, "What would a hard Brexit mean for company law?" (Edinburgh Centre for Commercial Law blog, 29 November 2016) <http://www.ecclblog.law.ed.ac.uk/2016/11/29/what-would-a-hard-brexit-mean-for-company-law/> accessed on 11 June 2017

The intention behind implementing the financial assistance ban was protecting the interests of the stakeholders which are affected by the actions of the company but lately it is observed that the complex language, difficulty in interpretation, ineffectiveness to fulfil the capital maintenance objective, presence of abundant statutory rules to enforce the same objective and the changing political and economic structure in UK makes the ban redundant.

It does not go along with the interests of the parties which need to be protected. It hinders with conducting business which is beneficial for the interests of all the stakeholders of the company and most importantly the costs involved outweighs the benefits it entails. The other regulations in place provide the same protection which the financial assistance ban was designed to fight at a much lesser transaction cost, less restrictiveness and increased efficiency[50]. Thus, it's time for UK to repeal the financial assistance ban to make way for fair commercial transactions.

[50] John Armour, supra note 11