Gaby Hardwicke SOLICITORS

Briefing Note: Life After Financial Assistance

An Introduction to the Guide

With effect from 1 October 2008, the prohibition on financial assistance (and the associated 'whitewash' procedure) by private companies in the acquisition of shares in private companies has been repealed. This removes a complicating factor in acquisitions but does it mean you can disregard the issue completely? This guide should not be relied upon as legal advice and you should contact us for advice on your specific circumstances.

Briefing Note
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Summary:
A guide to the changes to the rules of financial assistance and the whitewash procedure, relevant to share acquisitions.

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When purchasing the issued share capital of a company, you may be borrowing money from a bank to enable you to pay the purchase price. In such circumstances it is common for the bank to require a charge or debenture over the assets of the target company as security for the loan.

If the target company (or another private company) grants such security, it will be considered to be providing you with "financial assistance" to purchase the shares, something that was prohibited for both public and private companies under the Companies Act 1985 (the "1985 Act"). The prohibition under the 1985 Act also extended to any other form of financial assistance such as the target company providing a loan or making a gift to the purchaser, providing a guarantee of the purchasers' obligations, or granting a mortgage or any other form of security to the bank.

A private company was able to get around the prohibition by following a detailed procedure called "whitewash". Following the procedure incorrectly (or not at all) could lead to severe implications for all those involved including fines, disqualification as a director and imprisonment.

One of the key aims of the Companies Act 2006 (the "2006 Act") was to liberalise company law for private companies and as a result the prohibition against financial assistance was abolished for all transactions taking place on or after 1 October 2008.

The relaxation of the law does not mean a private company can or should provide financial assistance without further thought. While the procedure (and the associated cost involved) was often considered disproportionate, it did provide a useful opportunity for all parties involved in a transaction to really consider whether the company could afford to provide financial assistance.

Even with the prohibition now abolished, if there is any doubt as to the target company's solvency then it should not provide financial assistance. This will be of particular importance to any lending bank which will be granted security. If the target company is technically insolvent at the time and then fails, the security could potentially be set aside. We would not be surprised to see banks seeking further protection, for instance, by including a provision in a loan agreement forbidding financial assistance without their consent. Additionally directors may be in breach of their duties if the assistance being given is not in the creditors' interests. The directors themselves could also be liable for wrongful or fraudulent trading and the validity of the financial assistance may be called into question as a transaction at undervalue.

If you are a director of the company which is to provide the assistance (or will be at the time it is given), it is also vital that you satisfy yourself that you are acting in accordance with the duties you owe to that company. Of particular relevance is the duty to consider, in good faith, whether the transaction will promote the success of the company for the benefit of its shareholders as a whole. The 2006 Act provides a list of matters which need to be considered, such as the long term effect on the company, the interests of employees and the need to act fairly between all the shareholders.

As well as the duty towards ***shareholders*** there is also the duty to consider whether the transaction is for the benefit of the ***company*** giving the assistance.

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If the required corporate benefit cannot be found then you may be in breach of your duties as a director and it is possible the company may not have the capacity to enter into the transaction. We would strongly advise that, when entering a transaction of this nature, the matter should be considered in a board meeting and a statement of reasons why the transaction is considered to be beneficial should be included in the board minutes of the assisting company. This exercise will provide evidence that the matter was properly considered.

To go a step further it would also be possible to ask the members to pass a resolution ratifying the directors' actions in entering the transaction. If this can be passed unanimously (and if the directors are also shareholders, they are not allowed to vote), it should limit the scope for an individual member to challenge the transaction later on.

In addition to the above, the transaction must not result in an unlawful reduction of capital. This may become an issue if, for example, a company makes a cash gift to a shareholder to allow him to purchase further shares. If the gift is not made out of distributable profits, it will be an unlawful reduction of capital.

If you have never acquired a company by way of a share purchase, you may not have come across this issue before. It is clear that, despite the reforms, it remains important for full consideration to be given to any act of financial assistance, before the assistance is made.

If you would like to know more about this topic or our legal services, please contact Mark Williams on 01323 435955 or mew@gabyhardwicke.co.uk

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