



Alert

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Corporate Finance and Strategy



Companies Act 2006: financial assistance: the long-awaited relaxation of the rules for private companies comes into effect on 1 October 2008

Introduction

A number of provisions of the Companies Act 2006 (the 2006 Act) are now in force. As part of the phased implementation of the 2006 Act, further provisions will come into effect on 1 October this year. There will then be one final implementation date, 1 October 2009.

The changes to be made this October include the repeal of the existing regime contained in the Companies Act 1985 (the 1985 Act) prohibiting a private company from giving financial assistance for the acquisition of its own shares or those of its holding company.

Under the 1985 Act regime the giving of financial assistance was a criminal offence for both the company and the directors, and the transaction constituting the assistance was potentially void. Assistance could be given legitimately if a complex, time consuming and expensive "whitewash" procedure was followed; this involved approval by shareholder resolution, and confirmation of solvency from not only the company's directors but also its auditors. The statutory provisions were notable for being both draconian and opaque, so their repeal is to be greatly welcomed.

What is the extent of the repeal?

It will no longer be an offence for a private company to give financial assistance on or after 1 October 2008 for the purposes of the acquisition of its own shares or the shares of another private company even if the shares in question were acquired prior to that date (so if an acquisition has taken place prior to 1 October 2008, assistance may be given after that date to reduce or discharge a liability incurred in the acquisition).

What about public companies?

The statutory prohibition contained in the 1985 Act will continue to apply to public companies, and also

to private companies if the assistance relates to the acquisition of shares in a public company.

The prohibition presently contained in the 1985 Act to this effect will be replaced by similar provisions in the 2006 Act on 1 October 2009.

What about the 'whitewash' procedure?

The repeal of the prohibition removes the need for the whitewash procedure for private companies and the rules governing this will also be repealed this October. There is no equivalent whitewash procedure for public companies.

What impact will the changes have?

There are still several legal hurdles to be considered by private companies considering the provision of financial assistance in corporate acquisitions.

The directors will still need to be satisfied:

- that the proposed transaction is in the best interests of the company, bearing in mind particularly the new statutory duty of directors under section 172 of the 2006 Act to promote the success of the company for the benefit of its members as a whole; and
- that the proposed transaction does not constitute an unlawful distribution or other illegal reduction of the company's capital.

The directors should also be alert to the possibility that the transaction may be challenged for up to two years after the acquisition under insolvency legislation if it constitutes a transaction at an undervalue.

What practical steps should the directors take?

The directors should ensure that they identify the corporate benefit to the company of the transaction. When considering the transaction and whether to

approve it, they must bear in mind all their duties as directors. Their considerations of all relevant matters, together with their final decision, must be duly minuted.

The directors should take into account the effect of the proposed transaction on the net assets of the company, and its ability to pay its debts as they fall due. If net assets will be reduced, the directors should assess whether or not the company has profits available for distribution which could cover the amount of the reduction. The directors might feel more comfortable calling upon the auditors, or perhaps an independent third party, to calculate these figures.

The directors might wish to seek shareholder approval for the proposed transaction to protect themselves from a subsequent challenge by the shareholders on the grounds of breach of duty.

Any directors will, of course, also need to comply with any requirements of any lenders in respect of the proposed transaction.

What comfort will lenders be seeking?

The approach that lenders are likely to take is still not entirely clear.

At present, lenders will certainly continue to require comfort (principally from the production of appropriate

board minutes) that the directors believe that the borrowing itself, and the giving of any related guarantee and security, is in the best interests of the company and does not breach any capital maintenance rules. Such minutes should set out the commercial justification for the transaction, and the impact on the company's net assets and distributable reserves, as discussed above. If there is a risk of insolvency the minutes should also note the effect of the proposed financial assistance on the company's solvency and why the transaction is in the best interests of the company and/ or the creditors.

There has been some uncertainty as to whether lenders will also continue to require the comfort which they previously received from the whitewash process, that is the approval of shareholders, and more importantly confirmation of solvency from the directors and auditors. However, there is no overall consensus from lenders that they will not be seeking such approval or confirmation (and they might well do so if there were particular grounds for concern).

In the current financial climate we will have to see how market practice develops. We will be monitoring the situation and will advise you of developments in a future Alert.

How can Hammonds help?

We would be pleased to discuss with you in more detail any of the issues raised in this Alert or to help with any questions you may have on other aspects of the 2006 Act. If you would like any further information whatsoever, please contact your usual contact at Hammonds LLP or alternatively:

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