

**COMPANY LAW REFORM: FINANCIAL ASSISTANCE BY A COMPANY
FOR THE ACQUISITION OF ITS OWN SHARES - OUTCOME OF THE
NOVEMBER 1996 CONSULTATION**

A DTI consultation paper, issued in November 1996, invited views on revised proposals for reforming the law on financial assistance for the acquisition of own shares (sections 151-158 of the Companies Act 1985).

The Department received 26 responses to the paper. Virtually all the respondents supported the overall approach to reform proposed but were concerned about specific aspects of the proposals. On any given issue there generally appeared to be one approach which clearly commanded the support of the majority of respondents. In some cases this was not the approach suggested by the Department. Where this was the case the Department's proposals have been adapted to take account of views of respondents. The attached document, which was issued in April 1997, describes our conclusions following the consultation in relation to each main aspect of the proposed reforms. A copy of the original consultation paper is also attached.

The proposals will be implemented when Parliamentary time allows.

FINANCIAL ASSISTANCE FOR THE ACQUISITION OF OWN SHARES: CONCLUSIONS OF CONSULTATION (ISSUED APRIL 1997)

Set out below are the Department's conclusions following the November 1996 consultation exercise in relation to the main elements of its proposals for reform of sections 151-158 of the Companies Act 1985.

Proposals applicable to public and private companies

Geographic scope

The Department's proposals for the clarification of the geographical scope of the financial assistance provisions were welcomed by the majority of respondents. Therefore we propose to amend the Companies Act so that it applies to British companies providing financial assistance for the acquisition of their own shares or those of any British or foreign parent company. Financial assistance by a foreign subsidiary for the acquisition of the shares of a British parent company would not be covered.

Reversal of the Brady judgement

The proposal to reverse the effects of the Brady v Brady judgement through the introduction of a "predominant reason" test was broadly welcomed. However, several respondents were concerned that the new test, if it was not drafted very carefully, could suffer the same narrow interpretation by the courts as the current "principal purpose" test. It was suggested that it would be helpful if a Minister were to make a statement in Parliament or guidance were issued setting out how the new test was intended to be applied. This is something the Department will keep in mind.

Specific exemptions

The proposal to introduce a specific exemption for lawful commissions and indemnities for underwriting share issues was welcomed in itself but was not considered sufficiently broad by several respondents. A large range of similar types of transaction were suggested for inclusion in the exemption. In response to these suggestions the Department has amended its proposals to provide for a general exemption for legitimate costs associated with the issue and transfer of shares. This will be designed to cover costs incurred by the company where the beneficiaries will be a collection of investors (i.e. the assistance is not targeted at one particular person).

Particular concerns were expressed by some consultees about the lack of a specific exemption for low cost share dealing schemes. The Department remains of the view that a specific exemption for such schemes would not be compatible with Article 23 of the Second EC Company Law Directive. However, it is hoped that the nature of such schemes will mean that they are covered by the general exemption for the costs of issuing and transferring shares referred to above. Alternatively they may be covered by the predominant reason exception.

The Department also proposes to introduce a specific exemption for financial assistance for the purpose of a transaction which is itself exempt under section 153(3) or (4). For example, this would cover transactions such as borrowings to finance a dividend or the purchase of own shares.

Employee share schemes

Some consultees suggested that the exemption for employee share schemes in section 153(4)(bb) of the Companies Act should be broadened to encompass transactions between employees or employee trusts and outside investors. Currently only transactions between two parties in the same class are permitted. The Department has now included this suggestion in its proposals for reform.

Criminal sanctions

Respondents supported the proposal that companies giving financial assistance should be removed from the scope of the criminal sanctions for breach of the prohibition. It was agreed that a defence against prosecution should be introduced for officers of the company. A defence based on the three elements proposed by the Department was generally supported by respondents.

Civil sanctions

The majority of respondents welcomed the proposal to introduce a specific provision that a transaction should not be void solely on the grounds that it constituted unlawful financial assistance.

Proposals specific to private companies

Unlimited companies

The majority of respondents supported the Department's proposal to remove unlimited companies from the scope of the prohibition on financial assistance. The exemption would only apply where the financial assistance related to the acquisition of the shares of a company that was unlimited and there was no intermediate limited holding company.

Application of sections 151-154

Among those who expressed a view there was unanimity that, contrary to the Department's proposals, private companies should continue to fall within the scope of sections 151-154 of the Companies Act. It was argued that this was necessary so that no new uncertainty was introduced regarding the definition of financial assistance. It was also argued that the exemptions in section 153 of the Companies Act (and the new predominant reason exception) should be available to private companies. The Department has accepted these arguments and has amended its proposals accordingly.

Net assets test

Respondents generally supported the proposal for an exemption for small transactions which passed a 3% net assets test. However, they were opposed to the use of the term "non-materially prejudicial" on the grounds that it was unnecessary and could lead to uncertainty. The Department has amended its proposals so that the term is no longer used.

Some consultees were concerned by the proposal that when the net asset test was applied full account should be taken of potential liabilities under an indemnity or guarantee. The Department recognises that the proposal would require companies to take an unusually conservative approach but considers this necessary to ensure that only truly de minimis transactions pass the net assets test.

Whitewash procedure

A significant minority of respondents were concerned that the proposed whitewash procedure would not provide adequate protection for creditors. A majority of these respondents suggested that the situation could be remedied by requiring any financial assistance to be provided out of distributable profits. The Department has amended its proposals to require assistance to be provided out of distributable profits in all cases other than where the assistance is a necessary part of an arrangement that will, if completed, lead to an increase in the net assets of the company. This exception is designed to allow for transactions such as rescue finance where the overall package is clearly in the interests of creditors.

The majority of respondents considered that the whitewash procedure would provide adequate protection for members. Some respondents suggested that it was necessary to specify what information should be provided to members before they were asked to pass a resolution approving a financial assistance transaction. The Department agrees and has amended its proposals to specify in general terms the types of information which companies should provide to members.

The Department proposes that the whitewash procedure would only be available to private companies giving financial assistance for the acquisition of their own shares or that of another private company where there was no intermediate public holding company.

CONSULTATION PAPER ON FINANCIAL ASSISTANCE (ISSUED NOVEMBER 1996)

Introduction

1. Following earlier consultation on proposals for reform of sections 151-158 of the Companies Act 1985, the Department has concluded a much simpler approach is required.
2. We have reluctantly concluded that the scope for reform of the provisions applying to public companies is relatively small due to the constraints of the Second EC Company Law Directive. Therefore, we consider the best approach for these companies is to amend only those elements of the requirements that cause particular difficulty and to leave the overall framework intact. Whilst this framework is not ideal, it has the advantage that many of its aspects have been tested in the courts and companies and their advisers have experience of working with it.
3. The Second Directive does not apply to private companies. Therefore, we propose to replace the existing requirements with a much simpler and clearer regime.

Proposals for Public Companies

4. We propose that the existing framework of legislation contained in sections 151-154 of the Companies Act should be subject to the following specific amendments:

Reversal of the Brady v Brady judgement

5. The interpretation of the principal purpose and larger purpose exceptions contained in subsections 153(1) and (2) by the House of Lords in the Brady v Brady case has had the effect of narrowing the exceptions in a manner unintended when the legislation was introduced. Therefore the Department proposes to legislate to reverse the effect of the judgement. The intention is to replace the principal and larger purpose tests with a new "predominant reason" test. Financial assistance transactions would not be prohibited where the company's predominant reason for entering into the transaction was not to give financial assistance. We intend to make express provision that when applying this test, the reason for a transaction should be assessed from the company's perspective and that the fact that the transaction, or its manner, constituted financial assistance should be disregarded.

Specific Exemptions

6. Specific exemptions to the prohibition on financial assistance may only be introduced if they are compatible with the Second Company Law Directive. In implementing the Directive in 1981, the Department took the view that the Directive was not intended to prohibit those types of transaction specifically provided for in other parts of that or other Directives. Hence the list of exemptions provided in subsection 153(3).
7. Articles 8(2) and 39(g) of the Second Directive recognise that costs may be incurred in issuing shares. Section 97 of the Companies Act 1985 permits a company to pay commission to any person subscribing or agreeing to subscribe for its shares. Therefore, it appears appropriate that lawful commissions and indemnities for underwriting share issues should be added to the list of specific exemptions in section 153(3).

8. In response to earlier consultation exercises other categories of transaction have been suggested for exemption under section 153(3). It has been suggested that it is unclear whether the financial assistance provisions prohibit transactions such as:

- borrowing to release cash to pay a dividend or to redeem redeemable shares; and
- the performance of obligations lawfully incurred by the company.

9. In both cases the Department takes the view that the new "predominant reason" test proposed above should be effective in removing such transactions from the scope of the financial assistance prohibition. Therefore a specific exemption is considered unnecessary. The Department also considers a specific exemption undesirable because it would cast doubt on the validity of other types of transaction which were covered by the "predominant reason" exception but which were not specifically exempted.

10. There have also been calls for an exemption to be introduced which would permit companies to reduce the cost to private investors of acquiring the company's shares by operating a low cost share dealing service. The Department supports the objective of encouraging wider share ownership through lower dealing costs and recognises that the value of any financial assistance received by any given investor as a result of a low cost share dealing service is likely to be negligible. However, we have reluctantly concluded that low cost dealing services which would not be covered by the "predominant reason" test described above are unlikely to be compatible with the terms of the Second Directive. Therefore it is not possible to introduce a specific exemption covering low cost share dealing schemes.

Consequences of breach

11. The Department has greater discretion as to how it enforces the financial assistance prohibition contained in the Second Directive than it has with regard to interpretation of the scope of the prohibition itself. It appears to the Department, that the burden imposed by sections 151-154 of the Companies Act 1985 may be unduly high due to the severe penalties which apply to their breach.

Criminal sanctions

12. The Department considers it appropriate that breach of sections 151-154 of the Companies Act should continue to be subject to criminal penalties. The prohibition and the offences were designed to deal with a serious mischief and the Department considers that the deterrent effect of a criminal offence is unlikely to be matched by a civil penalty. However we have some sympathy with the argument that, due to the uncertainties attached to the provisions, an honest and conscientious person can fall foul of the general prohibition under section 151 despite having acted honestly, reasonably and in good faith. Previous consultation has indicated support for the introduction of a defence which would protect those who have honestly and conscientiously come to the view that the transaction concerned was not in breach of the section. Therefore we propose to introduce a defence against criminal sanctions where the officer of the company shows that:

- he acted in good faith in the interests of the company;
- he reasonably believed his action did not contravene the prohibition; and
- he had taken reasonable steps to establish that this was the case.

The successful use of this defence would not protect the officer against civil action for misfeasance or breach of trust.

13. In addition, we propose that the offence under section 151(3) should not be capable of being committed by the company whose shares are acquired with the financial assistance (or its subsidiary where the assistance is given by a subsidiary). The Department considers it undesirable that a company or group should risk having its capital further depleted, to the detriment of its members and creditors, by the imposition of a fine for breach of section 151. Therefore we propose to remove the possibility of prosecution of the company (or its subsidiary) for breach of section 151. Criminal prosecution for breach of section 151 would be limited to officers of the company (or its subsidiary).

Civil penalties

14. It has become established in common law that any transaction in breach of section 151 of the Companies Act is automatically void. It is understood that this has led to a reluctance by third parties, such as banks, to become involved in transactions involving financial assistance. Responses to previous consultation exercises indicated support for removing the automatic voidness of unlawful financial assistance transactions. Therefore we propose to make specific provision that a transaction would not be void solely on the grounds that it constituted unlawful financial assistance. However, it would remain possible for the transaction to be void or voidable for some other reason and for the company to seek to recover any loss from the transaction using any other remedies available to it (e.g. pursuing the directors and other persons involved for breach of duty, misfeasance or constructive trust).

Questions

(i) Do you support the specific amendments to the financial assistance provisions proposed above?

(ii) Bearing in mind the constraints imposed by the Second Directive, are there any other amendments you consider particularly important?

Proposals for Private Companies

15. The Department proposes whole-scale revision of the financial assistance provisions applying to private companies. We propose to remove unlimited private companies from the scope of the financial assistance prohibition completely. The prohibition is considered unnecessary as a creditor protection measure where the members of the company have unlimited liability. Protection for members is also considered unnecessary as any minority adversely affected by a proposed financial assistance transaction would be able to appeal to the court under section 459 of the Companies Act.

16. The Department proposes to remove limited private companies from the scope of sections 151-154 of the Companies Act and to replace sections 155-158 with a clearer general prohibition on financial assistance and a simpler gateway procedure.

The proposed new regime for limited private companies would be based on the principle that companies would be permitted to provide financial assistance provided that the assistance was not "materially prejudicial" to the company or the members of the company approved the transaction in advance.

17. Transactions which were not materially prejudicial to the company would be excluded from the scope of the financial assistance provisions. A non-materially prejudicial transaction would be defined as one under which the financial assistance was provided out of distributable profits and resulted in a reduction of less than 3% in the company's net assets. A company's net assets would be defined as the aggregate amount of capital and reserves shown in the company's most recently prepared balance sheet (i.e. either the balance sheet included in the accounts for the last financial year or any more recently prepared and audited balance sheet). A company with no net assets would automatically fail the 3% net assets test.

18. The 3% net assets test would be adapted where the assistance took the form of a loan, indemnity or guarantee. In the case of loans, the test would be whether the size of the loan exceeded 3% of the company's net assets and in the case of indemnities and guarantees whether the potential liability of the company if the indemnity or guarantee were enforced would exceed 3% of the company's net assets.

19. Where a proposed financial assistance transaction failed the "material prejudice" test the company would be permitted to enter into the transaction provided it obtained the agreement of its members before giving the assistance. It is proposed that a special resolution should be required approving the transaction and that companies be required to send a copy of the resolution passed to the Registrar of Companies. A fine would be imposed for failure to deliver a copy of the resolution to the Registrar within 15 days of the resolution being passed. There would be no specific provision giving dissenting members the right to appeal to the court for cancellation of the resolution. As argued above in relation to unlimited companies, section 459 of the Companies Act appears to provide dissenting members with adequate protection. In order to minimise the chance of the company's financial position altering significantly between the passing of the resolution and the transaction occurring a resolution would only remain valid for 8 weeks after it was passed.

20. The only effect of passing a resolution would be to validate the transaction concerned from the perspective of the financial assistance provisions. Therefore, it would not immunise the company, its officers or the transaction against the effects of any other applicable laws or regulations. In particular it would not protect the transaction or the directors of the company from action under insolvency law and all the usual rules relating to constructive trust and breach of fiduciary duty would continue to apply. For example a liquidator or administrator could seek to have the transaction set aside if the company was insolvent at the time the transaction was entered into or became insolvent as a result of the transaction. Alternatively action could be taken against the directors on the grounds of wrongful trading, misfeasance, breach of duty, constructive trust etc.

Subsidiaries

21. In the case of financial assistance being provided by a subsidiary for the purchase of shares in a parent company it is intended that the above provisions would only apply where both the subsidiary and the parent company were private companies. The existence of an intermediate holding company

which was a public company would not necessarily preclude use of the provisions. Companies would need to take advice on whether such a transaction fell within sections 151-154 of the Act.

22. The geographical scope of the rules for private companies would be limited to:

- UK companies providing financial assistance for the purchase of their own shares;
- UK companies providing financial assistance for the purchase of shares in a UK holding company; and
- UK subsidiaries providing financial assistance for the purchase of shares in a foreign holding company.

The legislation would not apply where a foreign subsidiary provided financial assistance for the purchase of shares in a UK holding company.

23. Where a UK subsidiary proposed to provide financial assistance for the purchase of shares in a holding company and a resolution was required to approve the transaction, the subsidiary, the holding company and any intermediate holding company would be required to pass a resolution approving the transaction. Where a subsidiary proposed to provide financial assistance for the purchase of its own shares and a resolution approving the transaction was necessary only the subsidiary would need to pass a resolution.

Consequences of breach

24. It is proposed that it should be a criminal offence by the directors of a company to enter into a financial assistance transaction in breach of the financial assistance provisions (i.e. where the transaction was materially prejudicial and was not approved in advance by members). However, as proposed above for public companies, a defence would be provided where a director could show that he honestly and reasonably believed that the transaction did not contravene the financial assistance provisions. The defence would be drafted in the same terms as that for public companies.

25. In addition, express provision would be made that a transaction would not be void solely on the grounds it constituted unlawful financial assistance. However, any other civil law remedies applicable to the transaction would remain available e.g. those relating to constructive trust, breach of duty etc.

Questions

(i) Do you support the exclusion of unlimited companies from the financial assistance prohibition and the overall approach proposed for limited private companies?

(ii) Do you consider the "material prejudice" test appropriate?

(iii) Do you consider the protection for members and creditors adequate?

(iv) Do you support the proposed approach for the treatment of subsidiaries?

(v) Do you agree with the proposals for the criminal and civil sanctions for breach of the provisions?