



LEGAL UPDATE

The death knell for the whitewash procedure? Not quite...

Given the recent changes to the law relating to financial assistance there is a danger that directors, lenders and other counterparties to transactions may assume that share acquisitions can now be entered into without further thought. This note aims to explain the law as it now stands and to highlight those areas which should still be very carefully considered prior to completing any transaction.

With effect from 1 October 2008, the prohibition on the giving of financial assistance by a private company for the purchase of shares in itself or in a private company which is its holding company has been repealed by the implementation of the Companies Act 2006. This means that the complex and lengthy “whitewash” procedure by which directors of private companies had to swear a statutory declaration as to the solvency of the company giving the financial assistance has been abolished. The prohibition on giving financial assistance will, however, continue to apply to public companies after 1 October 2008. It is important to bear in mind that any breach of the provisions regarding financial assistance is a **criminal offence** for both the company and any company officer in default.

Notwithstanding that the prohibition remains with respect to public companies, the current exemptions to the prohibition will be retained. The exemptions include the “principal purpose” exemption, the payment of lawfully made dividends, the allotment of bonus shares, lending money in the ordinary course of business and employee share schemes. The availability of these exemptions is subject to certain criteria being satisfied and professional advice should be sought before seeking to rely on any of these.

Although the Companies Act 2006 does not set out a replacement for the “whitewash” procedure and the intention is to simplify the procedure for private companies entering into transactions which would otherwise have been prohibited, it is **essential** that directors bear in mind that the implementation of the Companies Act 2006 has only abolished the statutory restriction on the giving of financial assistance by private companies. Importantly, the Companies Act 2006 has not “legitimised” the underlying transaction and there are still significant issues which should be considered by the directors of the company giving the assistance. This means that transactions which would previously have required a whitewash cannot simply be effected without further thought. Each particular circumstance will depend on the exact structure of the transaction in question, but a number of the factors which are likely to be relevant are set out below.

1. The directors of the company giving the financial assistance should still ensure that the company has power and capacity to give financial assistance in its memorandum and articles of association since lenders are still likely to insist on proof of an express power to give such assistance.
2. Now that the Companies Act 2006 has introduced codified duties for company directors, including the duty to act in good faith and in a way which promotes the success of the company and for the benefit of its members as a whole (Section 172, Companies Act 2006), it is good practice to ensure that any decisions, and the reasoning for those decisions, are recorded in the board minutes of the company

and ratified by means of a shareholder resolution. As it is essential that the giving of the financial assistance is in the best interests of the company, the commercial benefit to the company should be outlined in the company's board minutes and care should be taken to ensure that the directors have correctly identified that there is a commercial benefit to the company in entering into the transaction.

3. The directors of the company should also take steps to satisfy themselves as to the solvency of the company. This will generally require the directors to have considered the cash flow projections of the company and to have analysed the net asset position of the company.
4. Companies should also be careful to ensure that any financial assistance is not considered to be an unlawful distribution or a reduction of capital. An unlawful reduction of capital may take the form of:
 - a private company with insufficient distributable reserves making a gift of money to a shareholder so that the shareholder can purchase further shares in the company,
 - a private company with insufficient distributable reserves making a loan to a shareholder with a view to the shareholder purchasing further shares in the company where, at the time that the loan is made, the company is aware that there is no reasonable prospect of the borrower being able to repay it, with the result that the company would be required to make an immediate provision for this in its accounts;
 - a private company issuing a guarantee or creating security or assuming a liability in circumstances where it is likely that such guarantee, security or liability will be called upon or will fall due; and
 - a target company being asked post-acquisition to provide a loan in order to refinance the acquisition debt of the purchaser in circumstances where the provision of such loan makes it necessary to make a provision for this in the company's accounts.

The much welcomed repeal of the financial assistance prohibition in respect of private company transactions does not, however, mean that directors can proceed with share acquisition transactions without fully considering the transaction as a whole. Further, lenders will also be concerned to ensure that their lending and security structure is not tainted by any flaws in the underlying corporate deal and counterparties to the transaction will be concerned to ensure that the transaction is not subject to any vulnerability of being unwound at a later date.

I have attached a summary of the key points to the end of this update. If you would like to discuss any of these issues in greater detail please do not hesitate to contact me.



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KEY POINT SUMMARY

General

- the prohibition on giving financial assistance still applies to public companies or, broadly speaking, to group structures where a public company is involved
- with effect from 1 October 2009, foreign companies are not subject to the prohibition on financial assistance but foreign law advice is still essential to ensure the jurisdiction of incorporation of that foreign company does not have a similar prohibition
- the exemptions to the prohibition will remain unchanged in substance (principal purpose, dividends, money lending, employee share structures) but care needs to be taken when relying on any of these as the availability is restricted
- as at 1 October 2008, the existing provisions of the Companies (Northern Ireland) Order 1986 and the Companies Act 1985 in so far as they relate to private companies have been repealed; these provisions continue to apply to public companies for the time being
- with effect from 1 October 2009 it is intended that Sections 677-683 Companies Act 2006 will come into force and replace the existing provisions of the Companies (Northern Ireland) Order 1986 and the Companies Act 1985

For directors of companies proposing to give financial assistance

- the repeal of the prohibition does not give carte blanche to give financial assistance without further thought
- the solvency of the company proposing to give the assistance should be verified; this will generally include cash flow and net asset position analysis
- the giving of the assistance must be in the best interests of the company (Section 172 Companies Act 2006, corporate benefit etc)
- the transaction must not constitute an unlawful reduction of capital

For lenders and other counterparties to the transaction

- the company must have power and capacity to enter into the transaction
- consideration of any vulnerability (transaction at an undervalue or preference) should be carried out

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