Spotlight

**KEY POINTS**

- As regards the prohibition on financial assistance in the Companies Act 2006 in general:
  - The purpose and ambit of the prohibition is restricted to public companies and principally designed for creditor protection and the avoidance of preferential treatment of some shareholders;
  - As for the types of transaction prohibited, the courts have taken a substance over form approach which can encompass "break fee" agreements;
  - There is a materiality requirement although no statutory definition of "materiality" is provided;
  - As regards illegality and enforceability, if there is potentially a legal method to perform then it will be presumed it was intended.
- Potential defences and exceptions include:
  - The purpose defence;
  - Authorised transactions;
  - Loans and employee share purchases.
- Curiously for a criminal provision there are several aspects of the statute that are unclear.

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# Unlawful financial assistance: rising from the dead

There has been renewed focus on the prohibition on financial assistance from a company for the purchase of its own shares as a result of the criminal proceedings commenced regarding Barclays Bank in respect of transactions involving Qatari investors. This article considers the return to reliance on these prohibitions as they affect public companies (which continue to be subject to this regime) under the Companies Act 2006, the ambit of the legislation and the likely key issues to arise in civil or criminal proceedings.

## INTRODUCTION

The recent, well publicised prosecution by the Serious Fraud Office of Barclays Bank and certain of its officers, arising out of share purchase transactions on the part of Qatari investors, has brought a renewed focus and a new lease of life to the prohibition on financial assistance from a company for the purchase of its own shares in the UK Companies Acts. Although these provisions have been fashionable from time to time as a basis for civil claims for the recovery of assets by liquidators and insolvency office-holders, more recent cases have been sparse and criminal proceedings rare indeed. The Barclays affair relates to events in 2008 when the old Companies Act 1985 was still regulating this area. But the proceedings will still provide an insight into how the prohibition works and the defences that will arise in terms of public companies, in respect of which the provisions are very similar in the new Companies Act 2006. It seems timely therefore to revisit this area that has remained so quiescent in the armoury of the prosecution for so long.

## THE PROHIBITION IN GENERAL

### Purpose and ambit

Under the old Companies Act 1985, s 151, the basic prohibition on a company providing financial assistance for the purchase of its own shares affected both private and public companies. The major reform of the new Companies Act 2006, implemented from 1 October 2008, has been largely to remove the prohibition as it affected private companies. As it remains, the basic prohibition is now to be found in s 678 of the 2006 Act in the following form:

> '(1) Where a person is acquiring or proposing to acquire shares in a public company, it is not lawful for that company, or a company that is a subsidiary of that company, to give financial assistance directly or indirectly for the purpose of the acquisition before or at the same time as the acquisition takes place….
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> (3) Where–
>
> (a) a person has acquired shares in a company, and
> (b) a liability has been incurred (by that or another person) for the purpose of the acquisition,
>
> it is not lawful for that company, or a company that is a subsidiary of that company, to give financial assistance directly or indirectly for the purpose of reducing or discharging the liability if, at the time the assistance is given, the company in which the shares were acquired is a public company.'

It can therefore be seen that the prohibition affects both public companies and their subsidiaries (whether public or private) and applies to financial assistance given in advance of a transaction as well as after it is concluded. Moreover under s 679 the prohibition is extended to public companies which are subsidiaries of private companies. They must not provide financial assistance for the acquisition of shares in the parent company.

The basic purpose of the prohibition (which has been a part of UK companies' legislation since the 1920s) has remained the same: the protection of creditors against capital depletion and potentially of shareholders against inappropriate preference being given to other members. The point was put succinctly by the Court

of Appeal in the leading case of *Chaston v. SWP Group plc* [2002] EWCA Civ 1999; [2003] BCC 140 at [31]:

> '…that the resources of the target company and its subsidiaries should not be used directly or indirectly to assist the purchaser financially to make the acquisition. This may prejudice the interests of the creditors of the target or its group, and the interests of any shareholders who do not accept the offer to acquire their shares or to whom the offer is not made.'

It is right to note, however, that the legislation also currently reflects a European Union-wide prohibition on public company financial assistance in the Second Company Law Directive 77/91/EEC, OJ 1977 L26/1.

Breach of the provisions constitutes a criminal offence (see s 680 of the 2006 Act) and can result in any agreement providing for the financial assistance being rendered unenforceable on the grounds of illegality. There may also be civil liabilities for any director involved for breach of fiduciary duty and for others involved for the tort of conspiracy or for accessory liability for dishonest assistance in a breach of trust or for unconscionable receipt of property transferred in breach of trust. A good example of a case featuring most of these types of claim is *Belmont Finance Corp v Williams Furniture Ltd* [1979] Ch. 250.

One oddity regarding the criminal offence is that it is committed not only by the directors responsible at the target company but by the target company itself (hence the current prosecution against Barclays). It is an oddity because one of the primary purposes of the prohibition is capital preservation for the benefit of creditors – if the target company is fined then its assets are inevitably depleted by the fine to their detriment. It is also an oddity since in the context of civil claims the target company has always been regarded a victim of the unlawful assistance perpetrated in breach of duty by its directors. Thus in *Belmont Finance*, Buckley LJ described the position of the company in this way at 261–262:

> '…if the allegations in the statement of claim are made good, the directors of the plaintiff company must then have known that the transaction was an illegal transaction. But in my view such knowledge should not be imputed to the company, for the essence of the arrangement was to deprive the company improperly of a large part of its assets. As I have said, the company was a victim of the conspiracy. I think it would be irrational to treat the directors, who were allegedly parties to the conspiracy, notionally as having transmitted this knowledge to the company; and indeed it is a well recognised exception from the general rule that a principal is affected by notice received by his agent that, if the agent is acting in fraud of his principal and the matter of which he has notice is relevant to the fraud, that knowledge is not to be imputed to the principal. So in my opinion the plaintiff company should not be regarded as a party to the conspiracy, on the ground of lack of the necessary guilty knowledge.'

It is strange that the same logic is not applied in the criminal context so that, at the very least, there needs to be something very unusual in the circumstances to warrant a prosecution of the target company itself. It is unclear what these are in the case concerning Barclays.

## Approach to enforcement: substance over form

There is a statutory definition in s 677 of the 2006 Act regarding the forms financial assistance can take, namely gifts, guarantees, security or indemnity (other than an indemnity in respect of the indemnifier's own neglect or default), a release or waiver, a loan 'or any other agreement under which any of the obligations of the person giving the assistance are to be fulfilled at a time when in accordance with the agreement any obligation of another party to the agreement remains unfulfilled', or by way of the novation of, or the assignment of rights arising under, a loan or such other agreement. There is then a catch all for '*d) any other financial assistance given by a company where–(i) the net assets of the company are reduced to a material extent by the giving of the assistance, or (ii) the company has no net assets*'. All of these provisions are somewhat circular in that they begin by stating that 'financial assistance means … financial assistance given…' and then providing for a particular form.

The general approach of the courts to the meaning of the term "financial assistance" has been to emphasise that the language is one of ordinary commerce and to focus on substance over form. As explained in *Charterhouse Investment Trust Ltd v Tempest Diesels Ltd* [ [1986] BCLC 1 at 10 the court will '*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 and should not be strained to cover transactions which are not fairly within it*'.

This has led the court in cases such as *MT Realisations Ltd (in liquidation) v Digital Equipment Co Ltd* [2003] 2 BCLC 117 and *TFB (Mortgages) Ltd v Anglo Petroleum* [2007] BCC 407 to reject creative attempts to re-categorise transactions that, properly analysed as a matter of substance, were simply the fulfilment of an independent legal obligation separate from the purchase of shares, as within the prohibition on financial assistance.

Thus in *TFB* the court concluded that the security given to support the repayment of a commercial loan which the target company itself owed was not a form of financial assistance and nor was the repayment by the target of its own indebtedness.

On the other hand transactions that may not be expressed as financial assistance (or even which state it is excluded) but in reality have such an effect can be held to be within the provisions. *Thus in Paros Plc v Worldlink Group Plc* [2012] EWHC 394 (Comm) the court was prepared potentially to classify an agreement for the payment of a "break fee" (a payment on a failure to conclude a transaction) in the context of a reverse takeover as financial assistance:

'Even if … [the break fee] is a flat fee (as I have held it is), the break fee is "other financial assistance" and has a material effect on the net assets of Worldlink. It is financial assistance because it is a proposed financial payment which "smooths the path" towards the acquisition of the shares. It is not clear whether a break fee is always financial assistance. It has been argued, based on *dicta* in *Barclays Bank plc v. British & Commonwealth Holdings plc* [1995] BCC 1059 that in some circumstances a break fee could be characterised as an "inducement" rather than "assistance". However, in *Chaston*, Arden LJ indicated (at §44) that she did not consider *Barclays* to decide that an inducement was not financial assistance.'

The substance over form approach seems likely to feature heavily in the Barclays criminal proceedings where one of the essential issues appears to revolve around the proper categorisation of transactions which were expressly described as being for purposes other than financial assistance.

## Materiality

Often, however, the provision of inducements in the form of "break fees" will avoid falling foul of the prohibition on financial assistance on the basis that they do not come within the specific forms of financial assistance specified in s 677 and instead have to come within the catch-all provision of "other financial assistance" where the net assets of the target company have to be reduced to a material extent by the giving of assistance. The level of "break fee" is often low enough to be classed as immaterial. Strangely, however, for a provision carrying criminal consequences there is no statutory definition of materiality nor indeed any detailed guidance in the authorities. In *Parlett v. Guppys (Bridport) Ltd* [1996] BCC 299 the court rejected 5% as a rule of thumb and indicated that the percentage would depend on the circumstances. In the *Paros* decision 1% was referred to as a guide but exceptionally in that instance the company had negative net assets and so the issue did not arise.

## Illegality

The established position is that infringement of the criminal provisions prohibiting financial assistance renders the relevant agreement illegal and unenforceable. In the *Paros* decision the question arose as to whether this meant it was void or simply unenforceable or could be rescued by an amendment (making the assistance conditional on re-registration as a private company so that it would be lawful). The court favoured the approach of treating the agreement as not void but simply unenforceable and in any event considered that the offending clause ceased to be unlawful as a result of the amendment and was '*to be treated as either reinstated or rendered enforceable*'. The court also referred to the approach adopted in the House of Lords in *Brady v Brady* [1989] AC 755 where an order for specific performance of an agreement to give financial assistance was granted where there was a means by which it could be performed lawfully using an exception provided for in the statute. The parties are to be presumed to intend that the contract is to be performed in the lawful rather than the unlawful manner: per Lord Oliver of Aylmerton at p 783D.

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## DEFENCES AND EXCEPTIONS

There are a host of defences and exceptions to the financial assistance prohibition. These will no doubt be considered in some detail as the Barclays proceedings unfold and include the following:

## The purpose defence

Section 678(2) provides that a company is not prohibited from giving financial assistance for the acquisition of shares where '*(a) the company's principal purpose in giving the assistance is not to give it for the purpose of any such acquisition, or (b) the giving of the assistance for that purpose is only an incidental part of some larger purpose of the company, and the assistance is given in good faith in the interests of the company*'. Section 678(4) contains a similar exception for post-transaction assistance.

The leading explanation of how this defence is to be approached is that of Lord Oliver in *Brady v Brady*, at 779–780:

'one has, therefore, to look for some larger purpose in the giving of financial assistance than the mere purpose of the acquisition of the shares and to ask whether the giving of assistance is a mere incident of that purpose. My Lords, "purpose" is, in some contexts, a word of wide content but in construing it in the context of the fasciculus of sections regulating the provision of finance by a company in connection with the purchase of its own shares there has always to be borne in mind the mischief against which section 151 is aimed. In particular, if the section is not, effectively, to be deprived of any useful application, it is important to distinguish between a purpose and the reason why a purpose is formed. The ultimate reason for forming the purpose of financing an acquisition may, and in most cases probably will, be more important to those making the decision than the immediate transaction itself. But "larger" is not the same thing as "more important" nor is "reason" the same as "purpose." If one postulates the case of a bidder for control of a public company financing his bid from the company's own funds – the obvious mischief at which the section is aimed – the immediate purpose which it is sought to achieve is that of completing the purchase and vesting control of the company in the bidder. The reasons why that course is considered desirable may be many and varied. The company may have fallen on hard times so that a change of management is considered necessary to

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> avert disaster. It may merely be thought, and no doubt would be thought by the purchaser and the directors whom he nominates once he has control, that the business of the company will be more profitable under his management than it was heretofore. These may be excellent reasons but they cannot, in my judgment, constitute a "larger purpose" of which the provision of assistance is merely an incident. The purpose and the only purpose of the financial assistance is and remains that of enabling the shares to be acquired and the financial or commercial advantages flowing from the acquisition, whilst they may form the reason for forming the purpose of providing assistance, are a by-product of it rather than an independent purpose of which the assistance can properly be considered to be an incident.'

It seems therefore that the defence has a narrow application and there are few instances where it has been successfully relied on. One of them is the case of *Re Uniq Plc* [2011] 11 EWHC 749 (Ch) where what would otherwise be prohibited financial assistance was considered to be provided in good faith and for a larger purpose where a complex restructuring had been carried out in order to resolve liabilities to a pension scheme.

## Authorised transactions

Section 681 of the Act contains exceptions for sets of specific transactions that are otherwise permitted under company law. In effect the section makes clear, for the avoidance of doubt, that they are permitted. These include distributions of a company's assets by way of dividend lawfully made (so a lawful dividend which is made and then used to repay a loan to finance the purchase of shares is permitted).

Other categories are any distribution made in the course of a winding-up of a company; the allotment of bonus shares; any reduction of capital under the Act; redemption of shares under the Act; a purchase of own shares by a company under Chapter 4 of the Act; anything done pursuant to an order of the court under Part 26 of the Act (schemes of arrangement); and anything done under an arrangement made in pursuance of s 110 of the Insolvency Act 1986 or anything done under an arrangement made between a company and its creditors which is binding on the creditors by virtue of Part 1 of the Insolvency Act 1986 (voluntary arrangements).

## Loans and employee share schemes

Section 682 contains an exception where the lending of money is part of the ordinary business of the company and the transaction concerned the lending of money in the ordinary course of the company's business. There are also exceptions for the provision by the company, in good faith in the interests of the company or its holding company, of financial assistance for the purposes of an employees' share scheme or the acquisition of shares by employees or certain members of their family.

In the case of a public company there is a condition, however, that the company has net assets that are not reduced by the giving of the assistance, or to the extent that those assets are so reduced, the assistance is provided out of distributable profits.

In the case of a bank such as Barclays one can envisage this exception potentially having some relevance. However, much would revolve around whether the lending truly was in the ordinary course of business and whether the relevant conditions on distributable profits were met. The first requirement is key because, as the Privy Council made clear in *Steen v Law* [1964] AC 287 a loan made for the specific purpose of providing financial assistance to purchase shares could never be treated as in the ordinary course of business. By contrast a loan for other purposes which was part of the ordinary business of the bank but which happened to be used to finance a share purchase could be within the exception.

## CONCLUSION

It can be seen that the prohibition on financial assistance continues to have a wide ambit in relation to public companies. Curiously for a criminal provision there are several aspects of the statute that are unclear and have not had much light shed on them by the authorities. Also curious is the way in which the target company itself has been made a potential criminal offender under the provisions when it is usually viewed as a victim in the context of civil claims based on the statute. The defences are various but are narrower than might appear at first sight, hence the reason why the principal battle in the few recent cases has been over whether, as a matter of substance, the transaction was in truth one of financial assistance for the purchase of shares as opposed to a different form of commercial transaction altogether. In the coming months it will no doubt be revealed whether the Barclays prosecution has a similar area of focus. ■

*Further Reading:*

- Should financial assistance provisions hinder enterprising transactions? [2003] 7 JIBFL 257.
- Financial assistance in Singapore [2016] 2 JIBFL 103B.
- LexisPSL: Banking & Finance Practice note: Financial assistance.