



WING TIPS

Companies Act 2006 Massive Cost Savings on Acquisitions?

Introduction

Broadly speaking the Companies Act 2006 (the "**2006 Act**") will abolish the prohibition on private limited companies giving financial assistance and remove the whitewash procedure. Will this mean massive cost savings on acquisitions for investors? Will this be P45 time for lawyers and accountants who have made a career out of advising on the financial assistance prohibition? Is it sensible to change the law if the problem the legislation was designed to counteract could re-surface?

The Existing Restriction Explained

Section 151, as those in the know refer to the current prohibition in the Companies Act 1985 (the "**1985 Act**"), provides that neither a company nor any of its subsidiaries may give financial assistance for the purpose of the acquisition of the company's own shares or for the purpose of reducing or discharging a liability incurred in connection with such an acquisition.

To take a typical buy-out scenario, the purchaser is often a newly incorporated company and hence has no assets. Accordingly a funder is likely to require security from the target company or group for providing the acquisition finance. The giving of such security by the target company or group is the most common form of financial assistance. The whitewash is the name given to the procedure set out in the 1985 Act which relaxes the financial assistance prohibition for private companies. The procedure is underpinned by an auditors' report stating essentially that the company giving the financial assistance can afford to do so. In addition, all the directors of the company must sign a statutory declaration confirming its solvency.

The cost to companies of obtaining legal advice on the financial assistance prohibition and advising on structures to keep within the law has been estimated at £25,000,000 a year and this figure does not take into account management time and accountants' fees. Companies have had little choice but to take detailed advice however as the consequences of not doing so can be severe. Unlawful transactions would be void - for example, a funder's security would be unenforceable - and the directors of the company providing the financial assistance face a prison sentence as Section 151 carries criminal as well as civil sanctions.

The New Law

Since the early 1990s there has been much debate on how the financial assistance prohibition should be reformed. When the 2006 Act financial assistance provisions come into effect, due to be on 1 October 2008, there will be partial reform but not total abolition as was called for in many quarters and which would have followed the legal jurisdictions relaxed on this issue headed by the United States.

The New Regime

The 2006 Act provisions will replace in their entirety the 1985 Act provisions. The much cited headline for this change is that there will be no prohibition on private companies giving financial assistance and consequently that the whitewash procedure will also be consigned to history. However, this statement is not 100% accurate on either count.

If the target company is a public company the new prohibition will relate to the target company and any subsidiary of the target company giving financial assistance, whether such subsidiary is a public company or a private company.

Regime for Public Companies

The general prohibition on the giving of financial assistance by a public company will continue and lawyers will talk in terms of a Section 678 issue rather than the current Section 151 issue. Section 678 is almost a carbon copy of Section 151 (for example, criminal sanctions still apply) but is there really a need for public companies and private companies to be treated differently in respect of financial assistance?

The answer is "yes" but only in order to comply with EU law (it is worth noting that most European jurisdictions have much stricter financial assistance regimes than the UK as cross-border entrepreneurs will testify). However EU law is also under debate and a current EU Directive 2006/68/EC is expected to relax financial assistance law for public companies and the way in which such relaxation seems likely is by means of a solvency related whitewash process - sound familiar?

Areas of Uncertainty

The EU Directive should come into force six months before the 2006 Act financial assistance provisions and it is expected that the 2006 Act provisions will be modified before they come into force - not just on this issue but also on other issues. For example, the Government has promised to incorporate a saving provision in the final text of the 2006 Act to stop the common law rules on maintenance of capital from applying in circumstances where they could potentially prevent private companies giving financial assistance without a whitewash. There should also be clarification of another common law issue that only UK assistance-giving companies need to comply with the prohibition. In other words, the prohibition does not apply to overseas assistance-giving companies. Clarity has also been requested on whether a UK subsidiary is bound by the financial assistance regime if its holding company, the target, is an overseas company.

The abolition of the private company financial assistance regulations does not mean that directors and funders should enter into acquisitions without proper consideration because the mischief which heralded the first legislation in 1928 will, of course, still remain: being the potential for asset-stripping of target companies to the detriment of such companies' shareholders and creditors.

For the first time, the general common law duties of directors will be laid down in statute, also the 2006 Act, and this will add teeth to the directors' obligation to ensure that the relevant transaction is in the best interest of the company and does not affect its solvency. Directors will have ongoing responsibilities to creditors and enhanced duties to some other stakeholders. How hard a line funders will take to the softer regime is of concern to investors as funders might still insist that some form of auditors' report is given on the solvency of each company providing the assistance.

Conclusion

In summary, there will be cost savings for investors on advisors' fees in many situations although the extent of the savings will depend on whether funders will require some form of insolvency confirmation to replace the loss of the whitewash procedures on private company acquisitions. So long as the benefits of relaxing the financial assistance regime outweigh any cases of abuse, it should be more straightforward and cost effective to buy and sell companies once the 2006 Act of financial assistance provisions come into force, hopefully on 1 October 2008. There are however still some areas of uncertainty, so watch this space!

This article is a summary of relevant law and is not advice and may not be treated as such. If you would like advice on the issues covered please contact:

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